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Supreme Court, U. S.
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No.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1980.

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
PETITIONERS,

v.

ROBERT W. MESERVE AND BENJAMIN H. LACY, TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR,
RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

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Questions Presented.

1. When the lending of railroad cars by one railroad to another is required by federal law and the rate of compensation for car loans is set without taking into account the risk of non-payment in the event of bankruptcy of the borrower, must a classification among creditors sufficient to assure payment be accorded to the car-lending railroad in the reorganization of the car-borrowing railroad in order to avoid an unconstitutional taking?
2. Should the First Circuit's denial of a classification sufficient to assure payment to railroad per diem claimants in a railroad reorganization be reviewed by this Court because that decision frustrates national transportation policy and directly conflicts with Seventh Circuit decisions?

Parties.

Petitioners are the Chesapeake and Ohio Railway Company, the Baltimore and Ohio Railroad Company, and the Western Maryland Railway.* Respondents are Robert W. Meserve and Benjamin H. Lacy as Trustees of the Boston & Maine Corporation, Debtor, a railroad in reorganization.

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* The three Petitioners are all wholly-owned subsidiaries of the CSX Corporation, a Virginia corporation. CSX also owns the Seaboard Coastline Railroad Company and the Louisville and Nashville Railroad Company.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Opinions Below.

The opinion of the Court of Appeals for the First Circuit, — F.2d — (1st Cir. Oct. 6, 1980) appears in Appendix A (A1-A47). It affirmed in part and reversed in part the United States District Court for the District of Massachusetts decision reported at 468 F. Supp. 996 (D. Mass. 1979), which appears in Appendix A (A48-A68).

Jurisdiction.

The judgment of the Court of Appeals was entered October 6, 1980.[1] The appeal was from an order of the district court in

[1] By Order dated December 31, 1980, Justice Brennan extended the time within which Petitioners might file their petition for certiorari to and including January 15, 1981.

railroad reorganization proceedings under Section 77 of the Bankruptcy Act, 11 U.S.C. §205. Petitioners invoke this Court's jurisdiction to review that judgment by writ of certiorari under 28 U.S.C. §1254(1).

Constitutional Provisions and Statutes Involved.

United States Constitution, Amendment V:

> . . . nor shall private property be taken for public use, without just compensation.

In addition to the Fifth Amendment, this case involves Section 77(c)(2) & (7) of the former Bankruptcy Act, 11 U.S.C. §205(c)(2) & (7), and portions of the ESCH car service act which constitute part of Section 1 in the former codification of the Interstate Commerce Act, 49 U.S.C. §1. The relevant paragraphs within that section are (4), (5), (10), (11), (14)(a), and (17) as they stood prior to the October 17, 1978 enactment of Pub. L. 95-473, 92 Stat. 1337, revising and recodifying the Interstate Commerce Act. They are set forth in Appendix B.

Statement of the Case.

Petitioners, the Chesapeake and Ohio Railway Company ("the C&O"), the Baltimore and Ohio Railroad Company ("the B&O"), and the Western Maryland Railway ("the Western Maryland"), seek a Writ of Certiorari to the Court of Appeals for the First Circuit. By its judgment entered October 6, 1980, the court in Part I of its opinion upheld on statutory and constitutional grounds the district court's denial to Petitioners of such a classification among creditors of the Boston and Maine Corporation, Debtor, a railroad in reorganization,[2] as would assure payment in full of their $1.4 million of per diem claims.[3] The court thereby affirmed classi-

[2] Herein called "the Boston & Maine," whenever periods prior to the bankruptcy petition are discussed, and "the Debtor" or "the Trustees" (as appropriate) whenever the reorganization period is discussed.

[3] Petitioners' claims cover the period August 1, 1953 through March 12, 1970. Petitioners stipulated with the Trustees that, if paid at the rates set by the Interstate Commerce Commission ("ICC") in *Chicago, Burlington & Quincy R.R.* v. *New York Sus-*

fication of per diem claimants along with general creditors in ninth place among creditors and stockholders, and denied the appeals of Petitioners and other similarly situated railroads seeking classification sufficient to assure the ultimate payment in full of per diem claims.[4]

The district court's classification of creditors of the Boston & Maine was made in response to the Trustees' petition to fix the division of creditors and stockholders. As a part of its statutory duty under Section 77(c)(7) of the Bankruptcy Act, the district court decided that priority determinations are to be governed by the bankruptcy goals of debtor rehabilitation and equitable distribution of the debtor's property among creditors, and that national transportation policy as articulated by ICC orders requiring payment of per diem did not prevent the court's assignment of per diem claimants, along with general unsecured creditors, to the lowest category among creditors. 468 F. Supp. at 999-1001. For all practical purposes, classifying per diem claims in ninth place denied full or even substantial payment of those claims. (Per diem claims represent $8,582,000 of the total $143,973,380 claimed by creditors from Debtor's estate.)

In a separate, earlier order, the reorganization court had denied the car-owning railroads' petition for immediate payment of their per diem claims. *In re Boston and Maine Corp.*,

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quehanna & Western R.R., 332 I.C.C. 176 (1968), the per diem charges sought by Petitioners for that period totalled $1,385,108.42. Of this total, $763,196.56 is due the B&O; $425,374.80 is due the C&O; and $196,537.06 is due the Western Maryland.

By the decision below, appellants other than Petitioners were denied such a classification as would assure payment in full of their $7.2 million dollars of per diem claims.

[4] In part II of its opinion, which Petitioners do not question, the Court of Appeals reversed in part the decision of the District Court by determining that a separate class of creditors, with priority pursuant to Section 77(b) of the former Bankruptcy Act, should be created for "six months" claims, including per diem charges and other interline balances, which accrued in the six month period preceding filing of the reorganization petition if they meet certain tests.

456 F. Supp. 412 (D. Mass. 1978). The Court of Appeals for the First Circuit upheld that decision, 600 F.2d 307 (1st Cir. 1979) ("the immediate payment case").

When in its opinion below the Court of Appeals subsequently decided the appeal of the classification order, it adopted the holdings in its earlier immediate payment decision as dispositive of statutory questions concerning the low priority assigned to all per diem claims except six months claims. — F.2d at —, (A7). In effect, by its 1980 decision, the First Circuit decided that a priority for per diem claims which would assure eventual payment is not to be accorded for the same reasons it had given a year earlier in denying immediate payment of per diem claims. It also decided that low priority for per diem claims did not constitute an unconstitutional taking of property from the car-owning railroads without just compensation. — F.2d at —, (A7-A11).

The background of the present controversy is the history of per diem charges and the law concerning their level and method of payment. On November 15, 1977, Petitioners and Respondents entered into a stipulation concerning this history and also agreed about certain aspects of its relation to the legal history of per diem charges, thus limiting by agreement the issues presented to the courts below. A brief summary follows.

In the early days of railroading when a freight car reached the end of the line which owned it, the goods were removed from the car and reloaded in the car of the connecting railroad. This gradually gave way to the more efficient method of interchanging the car itself. Car lending eventually became mandatory when the ICC in 1911 ruled that a railroad could not refuse to permit its cars to pass onto the rails of a connecting railroad.

The amount to be paid by one railroad for the use of the car of another, the per diem rate, came to be determined contractually by the railroads in an agreement signed by the members of the organization which was the predecessor of the Association of American Railroads (the AAR). The contract included procedures for changing the rates from time to time. *Boston and Maine R.R.* v. *United States*, 162 F. Supp. 289, 291 (D. Mass. 1958).

An elaborate set of rules established by the AAR for settling per diem interline payments was given the force of law when in 1930 the ICC decided that all railroads must make car hire settlements in accordance with the per diem rules of the AAR, *Rules for Car-Hire Settlement,* 160 I.C.C. 369, 165 I.C.C. 495 (1930).[5]

In issuing that order, the ICC also issued its mandate that "this order shall continue until further order of the Commission." The Supreme Court struck down certain portions of the order but left the balance intact in *Chicago, Rock Island and Pacific Ry.* v. *United States,* 284 U.S. 80 (1931). This ICC order has *never* been revoked and was outstanding during all periods in question.

The per diem rules require that car hire reports be forwarded from the car-using railroad to the car-owning railroad by the 10th day of the second month following that in which the car is used ("the forty day rule"). Thus, if a car is used in January, it must be reported by March 10th (Rule 11.1 (a)). The rules require that settlement of amounts accruing for the use of cars shall be made monthly without regard to reclaims pending (Rule 12). These rules have been applicable throughout the dispute among railroads as to the level of charges.

Many years before any dispute began between these parties, Congress had, as part of the Interstate Commerce Act, enacted the ESCH Car Service Act, 40 Stat. 101, which, as amended by Transportation Act of 1920 (41 Stat. 456, 476) became 49 U.S.C. §1, Par. (10) through Par. (17). It imposed on every carrier subject to the Interstate Commerce Act the duty to establish and enforce just and reasonable rules and practices concerning car service, and declared every such unreasonable rule, regulation, or practice unlawful. At this point, therefore, the per diem rates had a basis that was both contractual (the AAR Agreement) and statutory (49 U.S.C. §1).

The long dispute over the level of per diem charges between car-lending railroads, including the Petitioners, and

[5] This case will hereinafter be referred to as the *Per Diem Rules* case.

the Boston & Maine, together with other car-borrowing railroads, began in 1953 when the AAR decided to raise the rates from $2.00 to $2.40. Several eastern railroads, including the Boston & Maine, refused to pay the rate set by the AAR and withdrew from the Agreement. *Boston and Maine R.R.* v. *United States*, 162 F. Supp. 289, 292 (D. Mass. 1958). In response, the car-owning railroads filed complaints with the ICC, alleging that the lesser charges which defendants had offered to pay were unjust, unreasonable, and noncompensatory in violation of those paragraphs of Section 1 of the Interstate Commerce Act which impose the duty on the carriers to charge only what is reasonable and which declare unreasonable charges to be unlawful. The car-owning roads chose not to invoke Section 1(14)(a), which allows the ICC to fix the charges. The complaint sought an order requiring all railroads to pay the rates set by the AAR. It was the defendants in that case, the Boston & Maine and the New Haven, who by their answer asked the ICC to fix the lawful rate. The ICC in *Chicago, Burlington & Quincy R.R.* v. *New York, Susquehanna & Western R.R.*, 297 I.C.C. 291 (1955) held that the AAR per diem rates were not higher than was reasonable and ordered all railroads to observe them. The Boston & Maine sought judicial review of the ICC's order in a three-judge federal district court for the District of Massachusetts; Petitioners were parties in the case. The court, in *Boston and Maine R.R.* v. *United States*, 162 F. Supp. 289 (D. Mass. 1958), first found that Section 1(11) of the Interstate Commerce Act required just and reasonable levels of per diem and that the ICC had the power to award damages for past or present unreasonable charges. The court went on to hold that the ICC had given inadequate consideration to mileage factors in determining the fairness of the rate and remanded the matter to the ICC for further proceedings. An appeal was dismissed in *Boston & Maine R.R.* v. *United States*, 358 U.S. 68 (1958).

In response to the remand of the three-judge Court, the ICC reopened the 1955 case and consolidated it with two cases instituted under Section 1(14)(a) of the Interstate Commerce Act. The proceedings before the ICC consumed a decade, during which the Boston & Maine continued to pay

Petitioners at pre-1953 rates. During this period, the Boston & Maine and the Petitioners settled accounts at the scheduled intervals set by the per diem rules, but the Boston & Maine submitted its reports at the pre-1953 per diem figure, the petitioning railroads drew drafts at the figures so reported and, in addition, submitted statements setting forth the difference.

The Petitioners, along with other car-owning roads, acted in a timely and diligent manner to preserve their rights while awaiting the ICC's decision. The C&O, on August 1, 1959, entered into an agreement with the Boston & Maine in which the latter agreed not to plead the statute of limitations until 90 days after final resolution (including court review) of the per diem cases before the ICC. The B&O and the Western Maryland, in 1961, along with many other railroads, brought suit in federal district court in the Southern District of New York to recover per diem charges according to AAR agreements. *Baltimore & Ohio R.R.* v. *New York, New Haven & Hartford R.R.*, 196 F. Supp. 724 (S.D. N.Y. 1961).[6]

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[6] The court in that case did not rely on the contractual basis for the rates but on the statutory requirement that the rates be "just and reasonable" rates.

Although the suit was brought to recover per diem charges pursuant to the AAR Agreements, the court found that the defendants had withdrawn from the AAR Agreement, 196 F. Supp. at 735, and *denied* summary judgment based *on contract.* The court cited the ESCH Car Service Act for the carrier's duty to establish and enforce just and reasonable rules and practices and the ICC's role in establishing and policing such rules. 196 F. Supp. at 728.

The court noted that under the contracts, both parties had the right to invoke ICC jurisdiction and both had done so, the plaintiffs by petition to the ICC to declare the rate of $2.40 reasonable; defendants by answer, petitioning the ICC to find that rate unreasonable and to fix a fair rate. 196 F. Supp. at 735. The court found that the effective withdrawal from the agreement did not mean defendants could "continue to use plaintiffs' cars without paying a *reasonable rate*"(emphasis supplied), 196 F. Supp. at 735.

As to eighty-eight plaintiffs, including Petitioners the B&O and the Western Maryland, the court ordered partial judgment in their favor as to liability and declared they were entitled to recover per diem charges based on a rate to be found just, fair, reasonable,

When on January 17, 1968, the ICC finally issued its report and order in the pending cases, *Chicago Burlington Quincy R.R.* v. *New York Susquehanna & Western R.R.*, 332 I.C.C. 176 (1968),[7] it did two things:

1. It fixed[8] past rates by stating a series of rates which it found to be fair and reasonable from 1953 to 1965 and by setting a formula to determine rates from 1965 to 1969, and

2. It fixed for the future new rates which included a mileage factor for car use beginning August 1, 1969.

Following the ICC's decision, the Boston & Maine (and the New Haven) returned to the federal district court in the District of Massachusetts seeking to enjoin and annul the report and order of the ICC. The original case in that court was reopened and consolidated with the new case. The three-judge district court considered both the ICC's action in fixing specific rates for the past and in setting forth a system to determine future rates. It sustained both aspects of the decision. The decision was upheld by the Supreme Court per curiam on November 10, 1969. Rehearing was denied on January 12, 1970. *Boston and Maine R.R.* v. *United States*, 297 F. Supp. 615 (D. Mass.), *affirmed*, 396 U.S. 27

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and non-discriminatory by the ICC, of which the ICC was to advise the court, for each month beginning with August, 1953, to be computed with interest. Entry of a final money judgment in favor of all plaintiffs, however, was stayed pending determination by the ICC of the per diem rate controversy then pending.

It is incorrect to view as merely contractual the obligation of the Boston & Maine to pay reasonable charges for the use of cars prior to the effective date of the rates prescribed for the future in the ICC's decision in *Chicago Burlington & Quincy R.R.* v. *New York, Susquehanna & Western R.R.*, 332 I.C.C. 176 (1968). In the *B&O* case, the court was concerned with what was fair and reasonable in terms of cost to the railroad conferring the benefit (the statutory test) rather than the value to the party benefited (the quantum merit measure).

[7] This case will hereinafter be referred to as the *Per Diem Rate* case.

[8] This is Judge Woodbury's characterization in *Boston and Maine R.R.* v. *United States*, 297 F. Supp. 615, 617 (D. Mass. 1969), *affirmed*, 396 U.S. 27 (1969).

(1969), *reh. denied,* 396 U.S. 1030 (1970). The petition for reorganization of the Boston & Maine was filed two months later.

When the petition for reorganization of the Boston & Maine was filed in the District of Massachusetts on March 12, 1970, and the affairs of the Debtor first fell within the exclusive jurisdiction of the reorganization court, the situation was as follows: the Boston & Maine owed the B&O, the C&O and the Western Maryland over $1,300,000 of per diem charges; the ICC had set the rates by which these amounts were calculated;[9] the three-judge federal district court for the District of Massachusetts had upheld the ICC's decision; the Supreme Court had affirmed; rehearing had been denied, and the matter was ripe for the parties to go back into court in the Southern District of New York for entry of an order completing the partial judgment in favor of Petitioners the B&O and the Western Maryland (and other railroads) which the court had entered on June 15, 1962. Petitioners would have done so were it not for the exclusivity of the reorganization court's jurisdiction and its Order No. 2, dated March 18, 1970, enjoining the prosecution of all litigation in other courts.

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[9] In the context of a response to the referrals of the district courts of Massachusetts and the Southern District of New York as to those charges for car use prior to August, 1969, and in the context of a prospective decree with respect to those charges for car use after August 1, 1969.

Reasons for Granting the Writ of Certiorari.

I. WHEN FEDERAL LAW REQUIRES RAILROADS TO LEND FREIGHT CARS TO OTHER RAILROADS AND THE RATE OF COMPENSATION FOR CAR LOANS IS SET WITHOUT TAKING INTO ACCOUNT THE RISK OF NON-PAYMENT IN THE EVENT OF BANKRUPTCY OF THE BORROWER, A CLASSIFICATION AMONG CREDITORS SUFFICIENT TO ASSURE PAYMENT MUST BE ACCORDED TO THE CAR-LENDING RAILROAD IN THE REORGANIZATION OF THE CAR-BORROWING RAILROAD IN ORDER TO AVOID AN UNCONSTITUTIONAL TAKING.

A. *Federal Law Required Petitioners, Car-Owning Railroads, to Lend Their Cars to the Respondent Debtor at Rates which Had the Force of Law.*

Since 1911, railroads have been required to interchange cars and no railroad may refuse to lend its cars to another railroad. *Missouri & Illinois Coal Co.* v. *Illinois Central R.R.*, 22 I.C.C. 39 (1911). This duty derives from §1, pars. (4), (10) and (11) of the Interstate Commerce Act. Carriers are pragmatically powerless to prevent a car received by a connecting road being further interlined to a more distant road. During the period for which Petitioners seek payment of per diem charges, the loan of any per diem car was for an indefinite period. *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 745 (1972).[10]

The car-owning roads did not voluntarily lend their cars nor could they control the duration of the loan. It is the mandatory nature of the car loans for which per diem claims are made that distinguishes per diem claims from all other debts treated by the reorganization court.

The Interstate Commerce Act provided not only for mandatory car loan but also for the corresponding duty of car-hire settlement, i.e., full and prompt reimbursement, Section 1, pars. (4), (5), (10) and (11). In 1930, in the *Per Diem Rules*

[10] The validation of incentive per diem rates in *Allegheny-Ludlum* eventually gave car-borrowing roads an economic incentive for prompt car return, but even today the car-owning roads exercise no direct control over car loans. During the periods for which Petitioners seek per diem charges, the per diem rates did not include any incentive element.

case, the ICC determined that per diem settlements must be made at AAR rates, unless the ICC otherwise determined a just and reasonable rate.

The courts have concurred in the ICC's interpretation of the Interstate Commerce Act and have emphasized that the obligation to pay per diem charges and the entitlement to receive them have the force of law. "There is not and cannot be any question that every railroad is entitled to be paid fair and just compensation for the use of its freight cars by another road." *Boston & Maine R.R.* v. *United States,* 162 F. Supp. 289, 295 (D. Mass. 1958). "The obligations imposed and the benefits to be received [under the 1930 ICC order in the *Per Diem Rules* case] are intended to be reciprocal, and put subscribers and nonsubscribers [to the AAR agreement] upon terms of equality." *Chicago, Rock Island, & Pacific Ry.* v. *United States,* 284 U.S. 80, 92 (1931).

B. *The Per Diem Rates Were Intended to Compensate Car-Lending Railroads for Costs of Ownership and Did Not Provide Any Profit.*

The ICC has interpreted the Interstate Commerce Act requirement that railroads compensate each other for the mandatory lending of cars by saying:

> The owner of a car, required to release possession thereof to another carrier . . ., may not be deprived of its use without compensation. On the other hand, the carrier obtaining the use of the car is required to accept possession for the purpose of continuing the transportation, and may not be required to pay therefor more than the average cost it would have incurred as owner of the car or by use of its own car. The two requirements cannot be met except by calculation of the average ownership burden based upon costs, measured with such accuracy as is reasonably possible and distributed among the car users and owners in a manner which can be found most equitable to all . . . . [T]he "compensation" mentioned in section 1(14)(a) of the Act relating to "basic" per diem does not include any element of profit to the owner of the car . . . .

Per Diem Rates case, 332 I.C.C. 176, 186 (1968). "It has long been generally recognized that car hire, however established,

should be enough reasonably to compensate the car owner for its costs of ownership and no more." *Boston & Maine R.R.* v. *United States,* 162 F. Supp. 289, 295 (D. Mass. 1958) (three-judge court).

The purpose of the compensatory level of per diem charges and the prompt settlement rules is to enable American railroad companies to operate their connecting lines so that "they will constitute one national system." *Missouri and Illinois Coal Co.* v. *Illinois Central R.R.,* 22 I.C.C. 39 (1911).

The list of cost elements to be included in the calculation of the per diem rate has been generally agreed upon by the courts and the ICC. *Chicago, Rock Island & Pacific Ry.* v. *United States,* 284 U.S. 80, 97 (1931) (interest, depreciation, insurance, taxes and other car-ownership costs); *Boston & Maine R.R.* v. *United States,* 162 F. Supp. 289, 295 (D. Mass. 1958) (per diem should be enough, but no more than enough, to cover the cost to the car owner of 1) repairs, 2) taxes, 3) depreciation, 4) interest on investment, and 5) miscellaneous expenses of ownership); *Per Diem Rates* case, 332 I.C.C. 176, 255 & 257-8 (1968) (repair and maintenance, taxes, and capital investment); *Chicago, Burlington & Quincy R.R.* v. *New York, Susquehanna & Western R.R.,* 297 I.C.C. 291, 297 (1955) (noting that the McCrea Commission in 1910 adopted the principle that the per diem charge should cover repairs, taxes, depreciation, interest on investment, and miscellaneous expense incidental to ownership. "This principle has been generally accepted as valid ever since . . . ."); *Per Diem Rules* case, 160 I.C.C. 369, 378 (1930) (per diem to reflect the average cost to the owner of freight car ownership and maintenance, and embraces cost of repairs, taxes, replacements, miscellaneous expenses, and interest on the investment). *In none of the ICC or court cases has the risk of non-payment ever been determined to be a cost element used in formulating per diem rates.*

C. *Petitioners, Car-Lending Railroads, Diligently Pursued Their Per Diem Claims Against the Boston & Maine, But Its Bankruptcy Prevented Collection.*

The legal history recounted in the Statement of the Case (pp. 2-9, *supra*) reveals that Petitioners, while continuing

to comply with the mandate of §1, par. (11) of the Interstate Commerce Act to lend cars, promptly acted to enforce their statutory right to receive just and reasonable compensation for their cars. The complaint in the first ICC proceeding was filed September 21, 1953, within two months of the Boston & Maine's notice that it would not pay the AAR $2.40 rate. Petitioner the B&O was one of the complainants and the Boston & Maine was named as a defendant. 297 I.C.C. at 292.[11] Immediately upon the ICC's entry of an order in that case, the Boston and Maine sought to have the order set aside; Petitioners contested that action as well (p. 6, *supra*). The remand by the three-judge court to the ICC, some five years after the initiation of legal action to recover the portion of per diem rates which the Boston and Maine refused to pay, confronted Petitioners with the prospect of further collection delays. Petitioners again acted promptly and diligently to preserve their rights, the C&O by obtaining a statute of limitations waiver (p. 7, *supra*), the B&O and the Western Maryland by bringing suit against the Boston & Maine (and the New Haven) in the Southern District of New York. In that case, where Petitioners the B&O and the Western Maryland received partial judgment, the court said of the litigation, then eight years old, "[I]n fairness to plaintiffs [who included the B&O and the Western Maryland, Petitioners here], we cannot overlook the fact that, while they were pursuing their remedy before the Commission in good faith . . . defendants' shifting position before the Commission has resulted in much delay and wasted effort to the financial detriment of plaintiffs whose cars the defendants continue to use . . . ." *Baltimore & Ohio R.R.* v. *New York, New Haven & Hartford R.R.*, 196 F. Supp. 724, 739 (S.D. N.Y. 1961).

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[11] On the day when the complaint was filed, payment of the per diem charge for the first car borrowed by the Boston & Maine after its August 1, 1953 announcement that it would not pay the $2.40 rate would not yet have become due. Only what Justice Frankfurter has called "the 20/20 vision of hindsight" makes believable that seventeen years, three months and twenty-two days would be gone before the course of litigation then commenced was concluded.

The course pursued by the Boston & Maine in ceasing to pay just and reasonable per diem and engaging in marathon litigation to stave off legitimate collection efforts by the car-owning roads frustrated the workings of the car interchange and necessarily weakened the financial position of the car-owning roads because it denied them current payments for current expenses. This practice of underpayment, eventually found by the ICC to violate the requirement of just, reasonable and non-discriminatory rates, continued throughout a period when there was a national railroad car shortage. *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742 (1972); *United States* v. *Florida East Coast Ry.*, 410 U.S. 224, 230 (1973); *Investigation of Adequacy of Car Ownership*, 323 I.C.C. 48 (1974).

Allowing the postponement of prompt collection of per diem charges through litigation to become non-payment through the assignment by the bankruptcy court of last-creditor priority to pre-reorganization per diem claims amounts to a taking of the property of the car-owning roads in favor of other creditors, thus weakening the remaining railroads at a time when railroads are of increasing importance to the nation.

D. *Without Inclusion of the Risk of Non-Payment among the Cost Elements Used to Calculate the Per Diem Rate, Priority for Per Diem Claims Which Will Assure Eventual Full Payment Is Constitutionally Required; Otherwise the Car-Lenders' Property Will Have Been Taken without Just Compensation.*

The decision below acknowledged that the extension of credit implicit in the loan of equipment was mandatory, and then proceeded as though per diem rates included a factor for bad debts, equating per diem with ordinary commercial debts. The court says, for example, that "failure to accord a special priority in reorganization to per diem claims . . . is . . . a refusal . . . to confer on per diem charges the special advantage of freedom from one commercial risk, the risk of becoming an unsecured claim in reorganization." It also says:

> Bad debt losses of the car-owning railroads in rail reorganizations are simply elements of cost incident to the

> massive system of interchanging freight cars, and unless the system as a whole is shown to burden the car-owning railroads unreasonably or arbitrarily or to deny them overall reasonable compensation for the mandated loan of their cars, there is no transgression of constitutional right.

— F.2d at —, (A11). The critical difference of per diem charges from ordinary commercial charges is that commercial creditors can set their prices to allow for the element of cost represented by the risk of non-payment. Because the bad debt element is a cost, but not one considered in determining the per diem rates, pp. 11-12, *supra,* the decision below is wrong in concluding that failure to accord priority to Petitioners and other car-lending railroads does not take their property without just compensation.

The twin assumptions on which per diem rates are founded are that 1) per diem charges will be collected promptly in full, and 2) they will be paid in all events. The railroads are neither financial risk-takers nor profit makers in their car service relationships as structured by the ICC, but involuntary lenders who are to be invariably reimbursed for current costs. To charge the Petitioners and other car-lending roads with the cost of risks (no profit allowed as compensation for taking them) is to flout the assumptions on which the per diem system is predicated. To inflict on railroads not yet bankrupt costs artificially postponed by roads on the verge of bankruptcy until they were in reorganization subverts the statutory purpose of just and reasonable compensation and results in an unconstitutional taking.

The only risks which the per diem rate is set to include are the risks that obsolete cars will not be used and that an oversupply of cars will exist, recognized in the car-day divisor factor. See the *Per Diem Rules* case, 160 I.C.C. 369, 378 & 444 (1930) and the *Per Diem Rates* case, 332 I.C.C. 176, 226-30 (1968). Use of the car-day divisor assures that these costs of car ownership will be shared proportionally by car users. There would be no need for a separate classification in bankruptcy for per diem claims if contemporaneous payment for the use of cars were universally observed or if the per diem rate included an adequate factor for the cost of bad debts.

Without car-lenders being able to stop car loans for non-payment of compensatory per diem charges and without a bad debt factor, a classification sufficient to assure payment of per diem claims is a constitutional necessity.

E. *The Decision below Conflicts with Decisions of This Court on the Taking of Property without Just Compensation.*

The decision below that Petitioners' claims may be so classified as not to result in compensation at the statutory just and reasonable rate for the Boston & Maine's use of Petitioners' freight cars from 1953 through 1969 does not accord with decisions of this Court concerning the Fifth Amendment requirement that private property not be taken without just compensation.

In *Kaiser Aetna* v. *United States,* 444 U.S. 164 (1979), a compensable taking was found in a decision that a pond had become a navigational water of the United States because creation of a public right of access impaired the owners' "right to exclude," a property interest which the government cannot take without compensation. There are other resemblances of this case to *Kaiser Aetna:* first, the economic impact of the regulation, *see* n.3, *supra,* 444 U.S. at 169 & 175; second, the interference with reasonable investment-backed expectations fostered by ICC decisions and orders but subverted by the decision below, *id.* at 175 & 179; and third, the forced loan of cars without payment as a physical invasion of property, *id.* at 180.[12]

Denial of priority to per diem claims, given the statutory requirement to lend cars, effects a taking of car-owning railroads' property because it gives a right of access to cars without a corresponding obligation to pay. If car-lending roads

[12] Three justices of this Court, in their dissenting opinion in *Kaiser Aetna,* 444 U.S. 164, 180 (1979), noted the voluntary and for-profit character of the Kuapa Pond developer's actions (and therefore, presumably, the foreseeability of the effects of the pond's becoming navigable waters with public access). Here Petitioners did *not* act voluntarily in lending their cars to the Boston & Maine and recognition should be given to the governmentally compelled character of acts for which the decision below would deprive them of compensation.

were ordinary private owners free of statutory compulsion to lend their cars, they would not have permitted the Boston & Maine car use at below-cost rates. The combined effect of a requirement to lend cars, a per diem rate set without consideration of the risk of non-payment, and status as an ordinary unsecured creditor in reorganization[13] is that the government has transferred from car-owning railroads to car-borrowing railroads a significant portion of the value of car loans for the years 1953 to 1969. The impact of such a loss on Petitioners, which remain among the principal car-supplying railroads of the nation, is substantial. And under the combination of compulsory car-lending and the denial below of a creditor classification adequate to pay per diem claims in full, car-lending railroads like Petitioners could not avoid the loss.

Two earlier decisions of this Court about railroads further buttress the analysis of low classification of per diem claims as a taking without just compensation. *Chicago, Rock Island & Pacific Ry.* v. *United States,* 284 U.S. 80 (1931) and *Chicago, Milwaukee & St. Paul R.R.* v. *Wisconsin,* 238 U.S. 491 (1915).

In *Chicago, Rock Island,* two aspects of the ICC order in the *Per Diem Rules* case were held to be unconstitutional as taking the property of car-lending roads. These were the provisions that granted the short lines two days free time for interchanged loaded cars and relieved the short lines from any car-hire charges whatsoever for coal cars received for return loading with coal. 284 U.S. at 96, 98. The court held that confiscation may result from the taking of the use of property without compensation as well as from the taking of title. "[A] regulation permitting the free use of property in the face of an express finding that the owner is entitled to compensation for such use cannot be regarded otherwise than as arbitrary and unreasonable." *Id.* at 97. If the short lines have insuf-

[13] For at least $1,313,758.51 of the Petitioners' total per diem claims of $1,385,108.42.

The stipulation below separately states Petitioners' claims from August 1, 1969 through March 12, 1970 as $71,322.91. The six months' claims (for the period September 12, 1969 to March 12, 1970) would form the bulk of the $71,322.91.

ficient profits, said the court, that cannot be remedied "by confiscating for their benefit the use of cars of other railroads." *Id.* at 97.

For the same reason, the financial ill health of the Boston & Maine may not be remedied by affording it seventeen years' use of cars at a less than compensatory rate. The decision below treating per diem claims other than six months claims as garden-variety unsecured debts penalizes the car-owning roads for years of lawfully abiding by car-hire rules, and unjustly enriches the secured creditors of the Boston & Maine from the proceeds of the Boston & Maine's noncompliance with ICC orders applicable to *all* railroads by their seventeen-year failure to pay Petitioners just and reasonable car-hire.[14] *See* pp. 10-11, *supra*, pp. 25-27, *infra*.

The Boston & Maine had neither regulatory nor judicial permission for paying a per diem rate of $2.00, a rate the ICC ultimately found not to be just and reasonable compensation. It is an affront to the regulatory compliance manifested by Petitioners to hold that the appropriation of the value of Petitioners' cars by the Boston & Maine is not a taking. *Compare Chicago, Milwaukee & St. Paul R.R.* v. *Wisconsin*, 238 U.S. 491 (1915) in which so minimal an intrusion as a state statute forbidding an unused upper berth to be let down if the lower berth is occupied as a limitation on the railroads' free use (and management of the use) of their property was held to be a taking. It is precisely the limited management discretion about its valuable property imposed by compulsory car-lending in conjunction with last-place classification among creditors which warrants reversal of Part I of the opinion below. *See also Delaware, Lackawanna* v. *Board of Public Utilities*, 85 N.J. L. 28 (1913) (requirement that railroad furnish free transportation for state officials is an unconstitutional taking).

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[14] On its face, the amount of Debtor's per diem accounts with Petitioners, n.3 *supra*, is significant. The Seventh Circuit recognized the precarious financial condition of many of the nation's railroads when it pointed out the ill effects of allowing railroads in reorganization to shift pre-organization per diem expense to car-owning roads. *In re Chicago, Rock Island and Pacific R.R.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied sub nom. Gibbons* v. *Atchison, Topeka & Santa Fe Ry.*, 429 U.S. 1092 (1977).

No factor which might exclude Petitioners' loss from the category of a taking appears here. No "spillover" effects on existing public interests were caused by Petitioners which would justify non-compensation for the taking. *See* Sax, *Takings, Private Property and Public Rights,* 81 Yale L.J. 149 (1971); Sax, *Takings and the Police Power,* 74 Yale L.J. 36 (1964). Indeed, Petitioners were required to share their property with a financially-troubled railroad during an extended period for below-cost rates, thereby providing the public benefit of continued operation of that railroad. Alternate uses of their cars which would have offered profits to Petitioners were not possible. *Compare Penn Central Transportation Co.* v. *City of New York,* 438 U.S. 104 (1978).

Petitioners have lost "one of the most essential sticks in the bundle of rights that are commonly characterized as property —the right to exclude others," *Kaiser Aetna* v. *United States,* 444 U.S. 164, 176 (1979), and have now been denied compensation for that loss. The result is to extinguish a fundamental attribute of property ownership and to frustrate the statutorily-protected expectation of compensatory payment for involuntary car loan. They have been prevented from choosing the best use of their property, *see Agins* v. *City of Tiburon,* 447 U.S. 255, 262 (June 10, 1980). Other creditors of the Boston & Maine, for no economically rational reason, have become the beneficiaries of a denial of compensation to Petitioners for their investment in cars throughout the period of a national car shortage. *United States* v. *Allegheny-Ludlum Steel Corp.,* 406 U.S. 742 (1972).

F. *The Constitutional Issue Will Also Be Presented Under the New Bankruptcy Act.*

In 1978 when Congress passed the new Bankruptcy Act, 11 U.S.C. §§101 et seq., it provided that any ICC order which would require the expenditure of funds from the bankrupt estate would not be effective unless the court approved it. 11 U.S.C. §1166. In railroad reorganizations begun on or after October 1, 1979, the reorganization court would therefore have discretion to provide for prompt payment of pre-reorganization per diem claims or to deny payment altogether of pre-reorganization or even current per diem

charges if the court decided debtor's circumstances and equity among creditors required it.

Because discretion not to pay ICC-ordered per diem claims is granted by §1166, the new act presents the prospect of the same constitutional questions on takings being raised by per diem claimants in reorganizations as are presented here. If railroads compelled to furnish car service are denied payment of per diem claims by courts supervising railroads in reorganization under the new act, they—like Petitioners—will have been deprived of the use and value of their property without compensation therefor.

The Petitioners' case therefore poses an important constitutional issue which is likely to recur.

II. This Court's Review of the First Circuit's Denial of a Classification Sufficient to Assure Payment to Railroad Per Diem Claimants in a Railroad Reorganization Is Necessary to Avoid Frustration of National Transportation Policy and to Resolve the Conflict between the First and Seventh Circuits.

A. *The Decision below Conflicts with Seventh Circuit Decisions.*

The interpretation of the Bankruptcy Act and the Interstate Commerce Act made by the First Circuit below in the Boston & Maine classification of creditors case differs markedly from that made by the Seventh Circuit in deciding *In re Chicago, Rock Island and Pacific R.R.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied sub nom. Gibbons* v. *Atchison, Topeka and Santa Fe Ry.*, 429 U.S. 1092 (1977) (*Rock Island*) and *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 632 F.2d 45 (7th Cir. Oct. 16, 1980) (*Milwaukee*).[15] The First Cir-

[15] Neither the First Circuit nor the Seventh Circuit view their decisions as in conflict with the Third Circuit decisions concerning per diem claims against the Penn Central, *In re Penn Central Transportation Co.*, 486 F.2d 519 (3d Cir. 1973), *cert. denied sub nom. Baker* v. *Indiana Harbor Belt R.R.*, 415 U.S. 990 (1974) (*Penn Central I*) and *In re Penn Central Transportation Co.*, 553 F.2d 12 (3d Cir. 1977) (*Penn Central II*). The Seventh Circuit, while denying a conflict in reasoning or result with the *Penn Central* decisions,

cuit considered the bankruptcy goal of unified control over a railroad debtor's financial affairs more important than transportation goals, whereas the Seventh Circuit held that the requirements of transportation law superseded the reorganization court's authority.

The courts in the two circuits arrived at opposite results for comparable issues. The per diem claims against the Boston & Maine and against the Rock Island included both pre-reorganization car use due before reorganization and pre-reorganization car use due during the reorganization.[16] The Seventh Circuit held that the trustees of the Rock Island were required to defer to ICC authority by paying immediate-

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537 F.2d at 913, recognized that its conclusion in *Rock Island* "departs to some extent from the holding of the Third Circuit." *Id.* at 912. The Third Circuit in *Penn Central II* noted that *all* drafts for payment of per diem accounts presented prior to conveyance of the Penn Central's properties to ConRail *had been paid,* 553 F.2d at 16, and distinguished post-conveyance per diem claims on the basis of the termination of ICC authority upon conveyance to ConRail which occurs under Section 601(b)(4) of the Rail Act, 45 U.S.C. §791(b)(4). 553 F.2d at 15. The First Circuit, while finding persuasive the Third Circuit rationale for denying immediate payment of per diem, admitted that the *Penn Central* cases were not in point below because the Penn Central's assets, unlike those of the Boston & Maine, had been conveyed to ConRail. 600 F.2d at 311. *See* — F.2d at —, (A7).

[16] The Rock Island petition was filed March 17, 1975. At issue were per diem claims for car use in January, February and March of 1975, due respectively on March 10 (pre-petition), April 10 and May 10 (post-petition). The court required all to be paid.

The Boston & Maine petition was filed March 12, 1970. At issue were $8.6 million of per diem claims for car use from August of 1953 to January of 1970, all due pre-petition, and the claims for car use in February and March of 1970, due respectively on April 10 and May 10 of 1970 (post-petition).

The *Penn Central* decisions were not comparable. In refusing payment of pre-reorganization claims due post-petition in its en banc decision in *Penn Central I,* 486 F.2d 519, the court's attention was not directed to ICC per diem rules and rates decisions. In its subsequent panel decision in *Penn Central II,* 553 F.2d 12, it held that it could not overrule the earlier en banc decision, and consideration of the administrative law of car service was therefore not required. *Id.* at 15, 17.

ly both categories of claims. The First Circuit allowed the reorganization court to control the timing of payment and classification of both.

The Seventh Circuit fully disposed of per diem claims in a single decision by granting them immediate priority. The First Circuit required two decisions to complete the disposition of per diem claims: in June of 1979, it denied the car-owning railroads' demand for immediate payment of per diem claims, 600 F.2d 307; in October of 1980, it decided that the reorganization court could assign bottom-level classification among creditors to per diem claimants.[17]

In *Milwaukee,* the Seventh Circuit said its *Rock Island* decision "resolved a conflict of statutory authority" between the two statutes "in favor of the power granted to the Interstate Commerce Commission." 632 F.2d at 45. It "held that a reorganization court is without power to exempt a railroad from compliance with the order of the Commission requiring priority of payment of charges accrued to pre-reorganization per diem accounts." 632 F.2d at 47, characterizing *Rock Island.* The Seventh Circuit distinguished per diem charges from ordinary debts. Payment of per diem charges is required by ICC orders and represents statutorily required cost-sharing without profit to the car-owning roads; it must be uniformly observed to achieve the national transportation goals of equitable cost-sharing among railroads and adequate national car supply. 537 F.2d at 911-912.

The courts in the First Circuit have explicitly repudiated the *Rock Island* rule, both in the district court decision below, 468 F. Supp. at 1000, and in the Court of Appeals' immediate payment decision, 600 F.2d at 312. The Court of Appeals called the Seventh Circuit's holding that the trustees of the Rock Island were to pay pre-reorganization per diem claims "a misconception about bankruptcy reorganization." *Id.* at 312. It did not view ICC orders as limiting the reorganization court's discretion, *id.* at 313, because it interpreted the *Per Diem* case as not fixing rates, and the *Per Diem Rate* case as not being an exercise of the full ICC jurisdiction, 600 F.2d at

[17] In the interim the court regarded the possibility of a priority for per diem claims as still open. *See In re Boston & Maine Corp.,* 618 F.2d 137, 140 & 141 (1st Cir. Mar. 13, 1980).

309. It characterized the ICC's action as "only . . . a general order applicable to all railroads." 600 F.2d at 312. The opinion below applied the reasoning of the per diem immediate payment decision to the present classification case. — F.2d at —, (A7).

The Seventh Circuit viewed transportation policy as the paramount consideration. Its concern for the unique situation of railroad per diem claimants is manifested in its view of per diem claimants as having a relation to railroads in reorganization which resembles copartnership more than creditor-debtor,[18] of the ICC's orders as compulsory, and of the trustees' obligation to rectify the pre-reorganization per diem noncompliance prior to adopting a reorganization plan. To the Seventh Circuit, payment of per diem claims (albeit a monetary transaction) serves such an important function in the overall car service regulatory scheme which links railroads' shared car use with uniformly enforced shared financing, that it very properly regarded payment of per diem charges as part of the operation of the railroad's business within the meaning of Section 77(c), 11 U.S.C. §205(c). The Seventh Circuit decisions thereby fulfilled the Congressional purpose of seeing that transportation policy is not disturbed by treating railroads in reorganization differently from solvent roads. *See Palmer* v. *Massachusetts*, 308 U.S. 79, 87 (1939); 76 Cong. Rec. 5358 (March 1, 1933) (remarks of Rep. LaGuardia).

The First Circuit viewed unified control over all of the railroad debtor's monetary transactions as the paramount goal and was willing to read ICC orders and decisions very narrowly in order to allow the reorganization court discretion unfettered by ICC car service regulation. For the First Circuit, the monetary aspect of the per diem payments obscured their function as an instrument of federal planning for the

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[18] Even the Third Circuit stopped short of equating the per diem claimant's status with that of an ordinary creditor and merely found the debtor-per diem claimant relationship to be "closer to that of debtor-creditor than that of trustee-beneficiary." 486 F.2d at 529.

This unique relationship must be given a conclusion commensurate with its beginnings.

nation's rail car supply. It treated per diem claims as though they were ordinary debts.

As Judge Adams suggested, concurring in *Penn Central II*, the best application of both the Bankruptcy Act and the Interstate Commerce Act to per diem claims cases is one which addresses the "practical problems confronting the railroad industry today" in light of Congressional expressions of concern "with the establishment and maintenance of a viable national rail system." 486 F.2d at 531. Such an approach was not taken below. The First Circuit opinion in the 1979 immediate payment case reasoned that pre-reorganization per diem claims should not be immediately paid because it thought that even a direct ICC order should not override the reorganization court's discretion to defer pre-reorganization per diem claims, given doubts about the ability of the debtor to sustain an immediate multi-million dollar charge and still continue to service the public. 600 F.2d at 312-313. However, the laconic incorporation by reference below of the reasoning in the 1979 decision to support the rather different decision to affirm a last-place classification for per diem claimants, — F.2d at —, (A7), lacked the thoughtful analysis of transportation consequences which the Seventh Circuit gave in *Rock Island* and *Milwaukee*. It also ignored the fact that the ability of the debtor to sustain the charge was not an issue in the context of the classification of creditors.

Immediate payment might have adversely affected the financial success of the reorganization, the viability of the debtor railroad as an operating concern, the estate's cash flow, and the size of the total payment to be made to all creditors. The classification decision is quite different; it is a matter of allocating the burden of the debtor's insolvency among the several creditors. The question is which of the creditors shall receive how much. Petitioning railroads should not, in view of Congressional concern for fair cost-sharing by the nation's railways,[19] be required to suffer serious financial losses as bottom-priority creditors while non-railroad creditors benefit. The 1980 First Circuit decision be-

[19] The National Transportation Policy, 54 Stat. 899, 49 U.S.C. preceding §1.

low does not serve reorganization goals such as debtor stability. The deferred payment allowed by the 1979 decision is not inconsistent with assignment to per diem claims of a classification sufficient to assure their eventual payment.

The conflict between the circuits begun by *Rock Island* and the First Circuit's immediate payment decision in 1979 is perpetuated by the decision below and *Milwaukee*. This continued conflict necessitates review by this Court to resolve the different interpretations of federal law by the First and Seventh Circuits.

B. *Railroad Per Diem Claimants' Differences from Other Creditors Justify Creation of a Separate Classification for Their Claims.*

The Bankruptcy Act requires the trustees of the Boston & Maine to operate its business subject to the ICC's jurisdiction. When on March 12, 1970, the Boston & Maine filed its petition for reorganization, Section 77(c) of the Bankruptcy Act,[20] expressly provided that the trustees' operation of the railroad was subject to all orders of the ICC concerning railroads:

> The ... Trustees ... shall have ... subject to the control of the judge and the jurisdiction of the Commission as provided by the Interstate Commerce Act ... the power to operate the business of a debtor.

11 U.S.C. §205(c).

The Bankruptcy Act also provides in Section 77(c)(7) that the division of creditors "shall not provide separate classification unless there be substantial differences in priorities, claims, or interests." 11 U.S.C. §205(c)(7). Per diem claims differ substantially from ordinary debts, pp. 10-12, *supra*, and under bankruptcy law alone there would be a rational and equitable basis for differentiating them from other debts

[20] Of the Bankruptcy Act of 1898, as amended, c.541, 30 Stat. 544, former 11 U.S.C. §205. On November 6, 1978 the Bankruptcy Act of 1978 was enacted. Under Title IV of that Act ("Transition"), railroad reorganizations like the Boston & Maine's are governed by former law, whereas railroad reorganizations filed October 1, 1979 or thereafter are governed by the new law. Pub. L. 95-598, Title I, §401 (a), 92 Stat. 2549.

because car loans are compulsory and per diem rates provide no profits, pp. 10-12, *supra*.

Fairness and equity are the essence of a Section 77 proceeding. *New Haven Inclusion Cases*, 399 U.S. 392, 448 (1970). How to apply the statutory requirement that a plan of railroad reorganization be fair and equitable in a given case must depend on the unique facts of that case. Here the statutory and regulatory assurance of payment for the mandatory loan of cars used in revenue-producing service by the Boston & Maine requires that compensatory payment be assured regardless of intervening bankruptcy. The requirement in the Bankruptcy Act of fairness here coincides with the requirement of deference to ICC jurisdiction. Both require that the dictates of car service law that payment for mandatory car loans be equally mandatory must be carried out here.

The Interstate Commerce Act requirement of just and reasonable compensation for car-hire is intended to spread the cost of freight cars proportionately among *all* railroads, including financially troubled and bankrupt roads. The ICC made this clear when it was specifically asked to grant, and refused, exceptions to the incentive per diem rates for less solvent roads:

> [T]he position of the bankrupt and marginal railroads had no merit because they sought, in effect, to require the car-owning railroads to subsidize them ... [E]xempting these latter railroads would be added pressure on non-bankrupt debit lines ....

Incentive Per Diem Charges—1968, 349 I.C.C. 303, 327 (1975). The ICC quoted with approval from the decision by the Administrative Law Judge:

> "We now come to the bankrupt and marginal railroads who seek exclusion because of their financial difficulty. These carriers are part of the national system of railroads and their obligation to provide shipping is not different from that of other companies .... The circumstances of the financially needy roads cannot be attributed to the car-owning railroads and it would be inequitable to require the car-owning railroads to subsidize carriers who are in financial distress. Moreover, exempting these carriers from paying I.P.D. [incentive per

> diem] would substantially increase the burden placed upon the remaining debit I.P.D. lines."

349 I.C.C. at 328. Given the ICC's conclusion that the public interest in the continued financial health of the car-owning lines required bankrupt and marginal carriers to pay full incentive per diem, the exemption of such carriers from payment of any portion whatsoever of basic per diem would have an even more damaging and unfair effect on Petitioners and other car-owning railroads.

The duty to furnish cars and the requirement of prompt and full payment for car service are two halves of a single regulatory plan intended to provide fairly for the railroads' joint burden of financing the national car fleet. To recognize one while abrogating the other, as the decision below did, is like substituting half a scissors or half a pair of tongs for the whole tool.

Petitioners submit that the *Rock Island* view that trustees of a bankrupt railroad are required to pay all of the railroad's outstanding per diem balances is the only interpretation of the statutes which fairly disposes of their claims. The deference to ICC jurisdiction required of the reorganization court in Section 77(c) for the purpose of achieving uniform application of transportation law to solvent and insolvent railroads alike and also the fairness requirement of bankruptcy law are violated by assigning per diem claims to the lowest class of creditors' claims.

C. *A Priority Which Will Assure Payment in Full of Per Diem Claims of Car-Owning Railroads Is Necessary to Fulfill the Purposes of Car Service Law.*

If per diem obligations of the Boston & Maine unpaid prior to reorganization can be relieved of their compulsory character and converted to ordinary unsecured claims by the filing of the petition, the Boston & Maine will have shifted to Petitioners a portion of their costs in contravention of the ICC's decision that even insolvent and marginal roads must pay their fair share of freight car costs. The long period during which the Boston & Maine was not in compliance with the prompt and full payment requirement increased the unpaid per diem claims of Petitioners while postponing the insol-

vency of the Boston & Maine. The necessary consequence for Petitioners was an impairment of their incentive and ability to buy new cars because they were not being fully reimbursed for the cost of cars they already owned.

Petitioners have paid more than their fair share of the cost of the national fleet of railroad freight cars and the Boston & Maine has paid less. This disproportionate burdening of Petitioners violates the Interstate Commerce Act.

D. *The Important National Interest in the Continuing Financial Health of Railroads Furnishing Cars for the National Pool Requires a Priority in Bankruptcy Which Will Assure Eventual Payment of Outstanding Per Diem Balances.*

In summarizing the ICC's position before it in *Rock Island,* the Seventh Circuit noted that

> deferred payment of per diem accounts will undermine a finely balanced regulatory scheme, force other railroads (some of which are themselves financially troubled) to subsidize the Rock Island's operations, and exacerbate an already severe national rail car shortage.

537 F.2d at 910. If in the view of the expert agency, deferred payment would have such effects, *a fortiori,* low classification (and the consequent severe decrease in the amount of per diem claims which Petitioners are likely to recover) would financially weaken Petitioners and other affected railroads at a time when Congress is funding railroad revitalization.[21]

E. *The Rule Articulated below Will Have Adverse Consequences for the Nation's Rail System.*

The prospect of losing substantial portions of shared car financing from railroads which refuse to pay (or under the new Bankruptcy Act from courts denying interline payments) and, in particular, Petitioners' loss of substantial

[21] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. 94-210, 90 Stat. 31, 45 U.S.C. §§801-854. The railroads are critically important to transport whatever coal will be used in the nation's energy future. *See* Stobaugh and Yergin, *Energy Future,* 87-91 (1979).

sums endanger the financial stability of car-owning railroads.

While Congressional thinking as articulated in §1166 may have changed future law, retroactive application of §1166 is specifically prohibited by Congress.[22] The Interstate Commerce Act as interpreted by the ICC was the law applicable during the period of Petitioners' claims; that law represented a Congressional decision to encourage an adequate car supply and to allocate costs fairly among car-using railroads. The domino effects of making railroad per diem creditors the last creditors to be paid in railroad reorganizations were not intended by that law.

Conclusion.

For all the reasons advanced above, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the First Circuit.

DATED: January 15, 1981

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[22] Cases commenced under the former Act are, under the new Act, to be governed throughout by the terms of the former Act. Such cases include *Rock Island, Milwaukee,* and *Boston & Maine.* The Seventh Circuit had made its *Rock Island* per diem decision before the enactment of the new act. In §1166 Congress chose not to *require* future acquiescence by reorganization courts to ICC orders as the Seventh Circuit had done, but it did allow courts the option of *permitting* priority payment of per diem claims in future reorganizations. Furthermore, Congress chose to leave standing the prospective effects of *Rock Island* on reorganizations such as this one which were begun at any time between November 6, 1978 and October 1, 1979.

Appendix A.

United States Court of Appeals
For the First Circuit

No. 79-1230

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
APPELLANTS.

No. 79-1231

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

MAINE CENTRAL RAILROAD COMPANY, ET AL.,
APPELLANTS.

No. 79-1234

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

PENN CENTRAL CORPORATION,
APPELLANT.

No. 79-1235

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CANADIAN PACIFIC,
APPELLANT.

No. 79-1236

IN RE.
BOSTON AND MAINE CORPORATION,
DEBTOR,

EASTERN ASSOCIATED COAL CORPORATION,
APPELLANT.

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[HON. FRANK J. MURRAY, *Judge*]

Before
KUNZIG,* *Judge, U.S. Court of Claims*
BOWNES, *Circuit Judge*
DOOLING,** *Senior District Judge*

Entered October 6, 1980

John T. Collins, with whom *Sherburne, Powers & Needham* was on brief, for Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company and Western Maryland Railway, appellants.

Paul B. Galvani, with whom *Reed Witherby* and *Ropes & Gray* were on brief, for Maine Central Railroad Company and Portland Terminal Company, Appellants.

George W. McLaughlin for Canadian Pacific, appellant.

Philip Burling, with whom *Peter A. Fine* and *Foley, Hoag & Eliot* were on brief, for Eastern Associated Coal Corporation, appellant.

Robert M. Gargill, with whom *Zdislaw W. Wieckowski, Choate, Hall & Stewart*, and *Charles W. Mulcahy* were on brief, for the Trustees of the Boston and Maine Corporation, Debtor, appellees.

Joseph H.B. Edward, with whom *Bingham, Dana & Gould* was on brief, for the First National Bank of Boston and Malcolm W. Hall Successor Trustees, under First Mortgage Indenture Dated December 1, 1919 of Boston and Maine Corporation, appellees.

* Sitting by designation.
** Of the Eastern District of New York, sitting by designation.

DOOLING, D.J.

The present appeals[1] in this railroad reorganization case challenge the district court's order, 468 F. Supp. 996 (D. Mass. 1979), determining the priorities of the creditors and stockholders in the reorganization of the Boston and Maine Corporation. Railroads which, as required by the Interstate Commerce Act and the cases decided under it, have interlined freight cars with the Boston & Maine appeal from the district court's refusal to accord their claims for per diem charges for cars furnished in the periods August 1, 1953, to July 31, 1969, and August 1, 1969, to March 12, 1970, such a priority in the classification of creditors as would assure full payment of the claims. The interlining railroads and Eastern Associated Coal Corporation appeal also from the district court's refusal to establish a separate class of creditors, to be accorded priority as "six months creditors," for the railroads' claims for per diem car hire, car repair, loss and damage, and freight overcharges for the six months preceding the filing of the involuntary petition against the Boston and Maine on March 12, 1970, and for the Coal Corporation's claim for diesel fuel furnished in the same six months period.

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[1] The appeals of the Committee of Interline Railroads and of Trailer Train Co. have been withdrawn. No briefs have been submitted in support of the appeals of Penn Central Transportation Company and Atchison, Topeka and Sante Fe Ry. The appeals of the Chesapeake and Ohio Railway Company, et al., and of Canadian Pacific present the issues concerning the classification of the per diem claims of the interlining railroads for the period August 1, 1953, through July 31, 1969, as well as of the railroads' claims for per diem car hire, car repairs and loss and damage for the six months preceding the date on which the involuntary petition was filed against the Boston and Maine. The appeals of Maine Central Railroad Company and Portland Terminal Company and of Eastern Associated Coal Corporation relate to the classification of claims for per diem car hire, freight loss and damage and overcharge, car repairs, and diesel fuel for the six months preceding the filing of the petition.

I

The railroads' per diem claims, aggregating $8,582,000, are described in Chief Judge Coffin's opinion for this court, 600 F.2d 307 (1st Cir. 1979), affirming the district court's refusal, 456 F. Supp. 412 (D. Mass. 1978), to order immediate payment of the per diem charges before payment of all other unsecured pre-reorganization claims.[2] On that appeal this court rejected the contention that because the trustees' operation of the Boston and Maine is subject to the jurisdiction of the Interstate Commerce Commission, *see* former Bankruptcy Act § 77(c)(2), 11 U.S.C. § 205(c)(2) (1976), and because the ICC has ordered payment of specific per diem rates at specific settlement times, neither the trustees nor the court have discretion to defer payment of the pre-petition per diem charges. 600 F.2d at 308. This court concluded that the ICC had not exercised its statutory power, 49 U.S.C. § 1(14)(a) (1976), to fix the rates for per diem settlements for the period August 1, 1953, to August 1, 1969, and that, so far as concerned the period after August 1, 1969, following the ICC's entry of a per diem rate order, the general power of the ICC to supervise the trustees' operation of the railroad did not outweigh the fundamental power of the reorganization court to set priorities for payment of pre-reorganization claims, Bankruptcy Act §§ 77(b), (c)(7), (l), and to schedule payment of such claims consistent with the need to conserve assets for rehabilitation of the debtor. 600 F.2d at 309-10. The court added that the 1968 ICC order that interlining railroads pay specific per diem charges, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, 332 I.C.C. 176, 241, 333 (1968), was an order of general application, and that, since non-payment of the per diem claims violated no specific order directed to the reorganization trustees, the remedial provisions of Section 1(17)(a) of the

[2] The district court decision recounts the sequence of proceedings leading to the ICC's fixing of per diem rates in 1968. *See* 456 F. Supp. at 413 n.2.

Interstate Commerce Act[3] could not be invoked. 600 F.2d at 312. The court observed that, fundamentally, the specific duty to pay the per diem charges due for the pre-reorganization period had been a duty of the railroad, and, after the filing of the petition, those charges became claims against the debtor, not claims against the trustees; the specific duty of the trustees, as operators of the railroad, to pay per diems was limited to the per diems incurred by the trustees in their operation of the road.[4] The court rejected the contrary reasoning of *In re Chicago, R.I. & P.R.R.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied*, 429 U.S. 1092 (1977), and indicated agreement with the result reached in *In re Penn Central Transportation Co.*, 486 F.2d 519 (3rd Cir. 1973), *cert. denied*, 415 U.S. 990 (1974), and which the Third Circuit reaffirmed in the different circumstances of *In re Penn Central Transportation Co.*, 553 F.2d 12 (3rd Cir. 1977). *See* 600 F.2d at 310-12.

On this appeal the interlining railroads argue, first, that since the interlining of freight cars is mandatory under the Interstate Commerce Act, 49 U.S.C. §§ 1(4), (10), (11), (14), (15), and (17), equity and considerations of national transportation policy unite to require that the roads receive just and reasonable compensation for the compelled loan of freight

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[3] 19 U.S.C. § 1(17)(a) provides that if "any carrier, receiver, or operating trustee" fails or refuses to comply with any order or direction of the ICC as to car service it shall be liable to stated penalties, recoverable in a civil action brought by the United States. Citations are to the Interstate Commerce Act, as amended, 49 U.S.C. § 1, *et seq.* (1976). Parallel sections respecting car service are now comprised in 49 U.S.C. § 11121, *et seq.*

[4] The court found in the terms of the Bankruptcy Reform Act provision, 11 U.S.C. § 1166, a resolution of any supposed contradiction between Section 77(c)(2) and Section 77 (l) in the requirement that both the ICC and the reorganization court approve payment for both pre- and post-reorganization per diem charges. The Congress in adopting Section 1166 rejected a Senate provision requiring the debtor to pay in cash current balances owed other carriers for interlining charges, including incentive per diems, for periods both before and after the filing of the petition.

cars; it is argued that the rail car fleet cannot be maintained at the level essential to adequate rail service unless payment of car hire is assured even in the case of the railroads that are in reorganization. The argument is essentially that made on the earlier appeal, and, so far as concerns the per diem claims for the period 1953 to August 1, 1969, is disposed of by what was then decided: the per diem claims for that sixteen year period were not based on an ICC order fixing rates and ordering payment at those rates; the ICC in *Chicago, B. & Q.R.R.* v. *New York, S. & W.R.R.*, 332 I.C.C. 176, 183, 244-57 (1968),[5] did, indeed, make findings as to the reasonableness of the rates charged for the preceding fifteen years, but those findings, it stated, were "of significance only as an aid to the courts in settling the amount of damages in the pending lawsuits" (*id.* at 183).[6]

The unpaid per diem charges for car use during the period August 1, 1969, to March 12, 1970, the date on which the reorganization proceeding commenced, aggregated $564,000; they were imposed at the rate determined by the order of the ICC, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, *supra*, 332 I.C.C. at 259; that order became final upon the Supreme Court's affirmance of the district court decisions

[5] The background and course of the litigation are outlined in the district court's decision in the "immediate payment" case, *In re Boston & Maine Corp.*, 456 F. Supp. at 413 n.2.

[6] In the suit to recover from the Boston & Maine and other railroads the difference between the amounts paid and the higher charges fixed by the Association of American Railroads, the district court deferred to the ICC's determination of the reasonableness of the AAR rates. *Baltimore & O. R.R.* v. *N.Y., N.H. & H. R.R. Co.*, 196 F. Supp. 724, 748-49 (S.D.N.Y. 1961). The ICC decision, *Chicago, B. & Q. R.R.* v. *New York, S.&W. R.R.*, 332 I.C.C. 176 (1968), fixing rates for the period commencing October 1, 1968, and making findings on the reasonableness of the rates for the 1953-1968 period, was sustained, *Boston & M. R.R.* v. *United States*, 297 F. Supp. 615 (D. Mass.), and *Union Pacific R.R.* v. *United States*, 300 F. Supp. 318 (D. Neb.), both *aff'd., without opinion*, 396 U.S. 27 (1969).

dismissing the railroads' actions to set the order aside,[7] and it was made effective August 1, 1969. This court's decision on the earlier appeal is dispositive of all the contentions raised on the present appeal as to this portion of the per diem claims except the constitutional argument. While Chief Judge Coffin's opinion was occasioned by the "immediate payment" contention of the railroads, it dealt directly and necessarily with the underlying issues of statutory interpretation and with the contention that a priority in reorganization for per diem claims would, by furnishing to the railroads an incentive for overcoming the chronic shortage of freight cars, better serve the interest of national transportation policy than would denying the priority in the interest of preserving the public service viability of bankrupt roads.

The railroads argue, on the constitutional issue, that since Congress has mandated the interline loan of cars and the ICC has fixed the per diem rates to be paid for the cars lent, denying to the car-owning railroads such a priority as will assure payment of the per diem claims in reorganization effects a taking of their property without due process of law, an unconstitutional taking akin to that found in *Chicago, R.I., & P. Ry.* v. *United States*, 284 U.S. 80, 96-100 (1931); there a divided court invalidated that part of the ICC order in *Rules for Car-hire Settlement*, 160 I.C.C. 369, 386-395, 445 (1930), that granted to the short line railroads two days of free time for interchanged loaded cars and denied compensation altogether in the case of cars received for return loading with coal from mines customarily dependent upon connecting carriers for car supply. The Court put the decision on the ground that, since the ICC had found that the owning roads were entitled to receive reasonable compensation in the form of a daily rental for the use of their general-service freight cars when on foreign lines, and that the $1 per car day charge then in effect was such reasonable compensation, the ICC could not,

[7] *See* note 6.

without inconsistency, relieve one class of railroads of the duty to pay that reasonable compensation: "The use of railroad property is subject to public regulation, but a regulation which is so arbitrary and unreasonable as to become an infringement upon the right of ownership constitutes a violation of the due process of law clause of the Fifth Amendment." 284 U.S. at 97.[8]

The rule, thus condemned by its very terms, effected at least a partial denial of compensation for car use in every instance of an interchange of cars between trunk line and short line. However, the failure to accord a special priority in reorganization to per diem claims neither denies an entitlement nor takes either property or its use without compensation. It is rather a refusal, on a ground of statutory policy, to confer on per diem charges the special advantage of freedom from one commercial risk, the risk of becoming an unsecured claim in reorganization. Whatever might be the case if interchange of cars was enforced in circumstances in which there was certainty of non-payment, it is not the case that a scheme of regulation that effects an appropriate public purpose may not, without violation of constitutional principle, entail random losses due to extrinsic factors. *See Baltimore & O. R.R.* v. *United States*, 345 U.S. 146, 148 (1953) (carload rates on certain kinds of fresh vegetables not violative of due process *merely* because they are noncompensatory; so long as regulations do not cause railroad to lose money on its overall business "it is hard to think that it could successfully charge

[8] The railroads also cite *Chicago, M. & St. P.R.R.* v. *Wisconsin*, 238 U.S. 491 (1915), in which the Court invalidated a Wisconsin law which provided that whenever a person engaged a lower berth in a sleeping car and the upper berth in the same section was neither engaged nor occupied, the upper berth should not be let down but should remain closed until engaged or occupied. The divided court held that the statute was not a reasonable exercise of state police power but a taking of property without compensation. The statute, like the short line rule, mandated a transfer of a value without compensation in money or justifying social value.

that its property was being taken for public use without just compensation");[9] *Indiana Harbor Belt R.R.* v. *United States*, 510 F.2d 644, 650 (7th Cir.) (ICC order requiring belt line to move empty cars to repair shops without charge not an unconstitutional taking of property without just compensation absent a showing as to belt line's overall operations), *cert. denied*, 422 U.S. 1042 (1975); *Western Air Lines, Inc.* v. *CAB*, 495 F.2d 145, 152-153 (D.C. Cir. 1974) (Board's denial of operating certificate to carrier that sought to operate only over profitable routes justified by consideration that supra-competitive profits of a single carrier already serving the route would enable it to undertake unprofitable local service that required such subsidization).

The railroads' contention must be considered strictly in terms of the necessary impact of the rules for car-hire settlement in the case of per diem claims against railroads in reorganization. But no extension of credit to insolvent railroads is inherent in the rules for car-hire settlement; the Commission in *Rules for Car-hire Settlement, supra*,[10] approved the rule of the "car service and per diem agreement" among the subscribing railroads which required that the car owner be furnished with a per diem statement within forty days after the end of each calendar month giving the number of days each car has been in the possession of the reporting road; the Commission noted that customarily the car owner, upon receipt of that information, drew on the using line for the amount reported after deducting per diems, if any, owed

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[9] *Government of Guam* v. *FMC*, 329 F.2d 251, 254 (D.C. Cir. 1964), and *Pan American World Airways, Inc.* v. *CAB*, 256 F.2d 711 (D.C. Cir. 1958), reach the same result on parallel facts. *Government of Guam* spoke of the result as deriving from "the compelling obligation of the carrier to render public service."

[10] An order giving effect to the findings of *Rules for Car-hire Settlement* was entered in *Rules for Car-hire Settlement*, 165 I.C.C. 495 (1930), *aff'd in part, reversed in part, Chicago, R.I. & P. Ry.* v. *United States*, 284 U.S. 80 (1931).

the other carrier. The accumulation of charges beyond the forty days was the product of the interminable controversy over rates, not a necessary consequence of interlining freight cars; the modest credit term implicit in the car-hire settlement rules could hardly be much shortened, and, given the importance of interchanging cars to the owning railroads' earning of freight revenue, the credit risk involved is not different from that generally incident to the conduct of industrial and commercial business. That some per diems of such short date may go unpaid in some railroad reorganizations, and that the loan of cars is required by law, do not combine to show a taking without just compensation. What must be shown to demonstrate unconstitutionality, and is not shown, is that the regulatory scheme as a whole, not excluding the incidence of the loss in reorganization cases arising from the extensions of credit required by the settlement rules, operates to take the property of the car-owning roads without just compensation, or is so unreasonable or arbitrary that it violates due process. The interline car-service rules and practices have evolved pragmatically in reasoned stages with but one only partly successful constitutional challenge (*Chicago, R.I. & P. Ry.* v. *United States, supra*) from the beginning position that a railroad could refuse to send its cars beyond its line when there was a car shortage since its first duty was to the business of its line, *Riddle, Dean & Co.* v. *Pittsburgh & Lake Erie R.R.*, 1 I.C.C. 374, 388 (1888); through the critical decision that local traffic does not enjoy rights superior to through traffic and that carriers must make reasonable rules and regulations with respect to the operation of through routes and the exchange, interchange and return of cars used on these routes, *Missouri & Illinois Coal Co.* v. *Illinois Central R.R.*, 22 I.C.C. 39, 48-49 (1911); to the later comprehensive ICC review and implementation of general car service standards in *Rules for Car-hire Settlement, supra*, and the succession of ICC orders of more recent years. In *Chicago, B. & Q. R.R.* v.

New York, S. & W. R.R., 332 I.C.C. 176 (1968),[11] the Commission, accepting the concept that car hire should be enough reasonably to compensate the owner for its costs of ownership and no more,[12] concluded that per diem charges should constitute no more than a sharing of cost, and should not include any amount for the value of the use of a car. *Id.* at 186-87.[13]

Bad debt losses of the car-owning railroads in rail reorganizations are simply elements of cost incident to the massive system of interchanging freight cars, and unless the system as a whole is shown to burden the car-owning railroads unreasonably or arbitrarily or to deny them overall reasonable compensation for the mandated loan of their cars, there is no transgression of constitutional right. No such showing was attempted, nor is it suggested that it could be made.

II

The claims for which priority is asserted under the "Six Months Rule" do not exceed $3,000,000 and include per diems for the period commencing September 13, 1969; priority is also claimed for the greater part of the same claims under the "Necessity of Payment" rule, but for some $400,000 of claims priority is sought under the Necessity of Payment rule only.

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[11] For the history of the ICC decision *see* note 6, *supra*.

[12] *Boston & Maine R.R.* v. *United States*, 162 F. Supp. 289, 295 (D. Mass.), *appeal dismissed*, 358 U.S. 68 (1958), is to the same effect.

[13] More recent decisions have sustained further ICC action respecting interchange of cars. *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742 (1972), approved as reasonable under Section 1(14)(a) two car service rules promulgated in 1969 by the Commission which required freight cars, after being unloaded, to be returned in the direction of the lines of the road owning the cars. The Court, reviewing the car service history of the railroads, said that, "The freight cars of the Nation thus became in essence a common pool, used by all roads." *Id.* at 743. And in *Ann Arbor R.R.* v. *United States*, 368 F. Supp. 101, 112-13 (E.D. Pa. 1973), *aff'd without opinion*, 419 U.S. 807 (1974), the courts sustained the Commission's incentive per diem rules under the 1966 amendment to Section 1(14)(a).

The district court held that to establish a priority under the Six Months Rule the creditor had to show that its claim was for a necessarily incurred current operating expense of the railroad, that it accrued within the six months preceding the filing of the reorganization petition, and that the goods or services were furnished in the expectation of payment from current railway operating revenues and not in reliance on the railroad's general credit. 468 F. Supp. at 1002. The court held further that the creditor had to show that there existed a fund in which qualifying six months claims would have a priority, that is, a "current debt (or expense) fund" comprised of current earnings of the six months period and during the reorganization or, absent a surplus of such earnings, corpus of the reorganization estate to the extent that such earnings have been diverted to it for the benefit of the railroad's mortgagees.[14] *Id.* at 1002-1005. The court concluded from the evidence that, treating depreciation as properly deductible in determining the amount of surplus earnings available for a "current debt fund," no surplus revenues had accrued either in the six months preceding the filing of the reorganization petition or during the reorganization proceeding; that, in addition, contributions to railway operating income and to the reduction of railway operating expenses had been made from the proceeds of sales of mortgaged property and from sales of scrap derived from mortgaged property; and that, finally, even if the net railway operating deficit for the relevant period, $42.5 million, were reduced by disallowing capital expenditures for property and improvements of $12.9 million, payments of pre-reorganization secured obligations of $5.6

[14] The district court held that Six Months Rule creditors were not entitled to a priority in unmortgaged assets; the court declined to follow dicta indicating a contrary assumption in *In re New York, N.H. & H. R.R.*, 278 F. Supp. 592, 598 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), and in *In re Penn Central Transp. Co.*, 458 F. Supp. 1234, 1321 n. 81 (E.D. Pa. 1978). 468 F. Supp. at 1007-08.

million, and estimated six months claims of $3 million, there would remain a net railway operating deficit of $21 million and an adjusted deficit in income available for fixed charges of $11.7 million. *Id.* at 1005-07. The district court rejected the claim for priority under the "Necessity of Payment" rule on the ground that the rule was not one of priority but of payment, and that it is inapplicable where, as in the present case, no creditor claiming under the rule had demanded payment of its claim as a condition to providing goods or services to the debtor, and the trustees never sought authority to pay the claims. *Id.* at 1008.

A

The Six Months Rule was recognized but not given precision of definition in one sentence in Section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1976):

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.[15]

The Six Months Rule emerged out of the practice of initiating railroad receiverships with an order appointing a receiver and authorizing or directing him to pay from operating receipts certain expenses incurred in the period immediately preceding the receivership. Thus the 1867 receivership order in *Gurney* v. *Atlantic & Great Western Ry.*, 58 N.Y. 358 (1874), directed the receiver to pay and discharge out

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[15] When first enacted in 1933, 47 Stat. 1474, the provision appeared in Section 77(c), and the first part read:

> For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver . . .

The language of the 1978 Act, 11 U.S.C. § 1171(b), is the same in substance as that of Section 77(b).

of the balance of receipts, after paying the expenses of maintaining and operating the road, arrearages owing to laborers and employees for work in connection with the railway and such sums as were actually due for material and supplies furnished for the use of the company's railways. No general principle, analogous to that in admiralty, was thought to give priority to the last creditors who furnished necessary repairs and supplies to a railroad. *Galveston, H.&H. R.R.* v. *Cowdrey*, 78 U.S. (11 Wall.) 459, 480-82 (1871). As the court said in *Duncan* v. *Mobile & O.R.R.*, 8 F.Cas. 17, 19 (C.C. S.D. Ala. 1876) (No. 4,137):

> The fact that the floating debt was contracted in good faith for the benefit of the railroad company's property, and therefore for the benefit of the bondholders, is true of perhaps all such debts. But that does not give the floating debt creditors any ground upon which to claim that their debt should be paid first.

Nevertheless, receivership orders continued to authorize payment of wage and supply claims that accrued over various periods, ranging up to eight months before receivership. *E.g. Skiddy* v. *Atlantic M. & O.R.R.*, 22 F. Cas. 274, 279-80 (C.C.E.D. Va. 1879) (No. 12,922) (reciting terms of 1876 receivership order); *Taylor* v. *Philadelphia & Reading Co.*, 7 F. 377 (C.C.E.D. Pa. 1880) (reviewing terms of several pre-*Fosdick* receivership orders). On the eve of *Fosdick* v. *Schall*, 99 U.S. 235 (1879), the practice of allowing payment for operating expenses of the pre-receivership period was stated in broad terms in *Turner* v. *Indianapolis, B. & W. Ry.*, 24 F. Cas. 366 (C.C.D. Ind., S.D. Ill. 1878) (No. 14,258); the court observed that generally railroads were dilapidated when receivership started, the first receipts were used to rehabilitate the road, and the pre-receivership claims for labor and supplies were paid by later order; the court emphasized that a railway is a matter of public concern and that public as well as private interests require its continued operation. The court said that its experience

> . . . has satisfied it that practically, it would be well nigh impossible, looking at things as they actually exist, to operate the roads by receivers without some allowance for claims of the character mentioned, existing at the time of their appointment, and that the limitation already stated [*i.e.*, to six months, by analogy to the Illinois lien statute] is not an unreasonable one, in view of all the circumstances.

24 F.Cas. at 367. But the court in *Turner* thought it desirable that the bar obtain from the Supreme Court a decision enunciating some just principle that might be a guide in such cases. *Fosdick* v. *Schall*, one of three cases argued and decided together,[16] is said to have been decided "after a general invitation had been extended to the members of the bar of [the supreme] court interested in like cases, to present briefs on the questions arising in that case." *See Atkins* v. *Petersburg R.R.*, 2 F.Cas. 90, 92 (C.C.E.D. Va. 1879) (No. 604).

Fosdick v. *Schall* rejected a conditional vendor's claim for "rent" of gondola cars for the six months preceding and several months following receivership for a number of very sufficient reasons. But the Court sought to establish a basis in principle for the payment of certain pre-receivership claims. The Court commenced by saying that a court, asked by a mortgagee to appoint a receiver in a mortgage foreclosure suit

> . . . in the exercise of a sound judicial discretion, may, as a condition of issuing the necessary order, impose such terms in reference to the payment from the income during the receivership of outstanding debts for labor, supplies, equipment, or permanent improvement of the mortgaged property as may, under the circumstances of the particular case, appear to be reasonable.

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[16] The two cases argued with *Fosdick* v. *Schall* did not deal with the Six Months Rule, but followed *Fosdick* v. *Schall* in holding that the lien of the railroad mortgage did not extend to cars, *Fosdick* v. *Car Company*, 99 U.S. 256 (1879), or locomotives, *Huidekoper* v. *Locomotive Works*, 99 U.S. 258 (1879), purchased under contracts of conditional sale.

99 U.S. at 251-52.[17] Noting that a railroad foreclosure case is rarely completed without concessions by the parties from their strict legal rights, that much of railroad business is done on credit, and that often debts for "labor, supplies, equipment and improvements" are deferred so that bond interest may be paid and disastrous foreclosure postponed, the Court continued:

> In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment, and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees.

Id. at 252-53. Saying that if the mortgagee sought the extraordinary equitable relief of receivership, it had to do equity in order to get equity, the Court continued:

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[17] The 1875 receivership order in the *Fosdick* foreclosure directed the receiver to pay all debts due for labor and services rendered within the preceding three months and all debts for "engines, iron, wood, supplies, cars, or other property purchased within said period of three months for the use of the company."

We think, also, that if no such order is made when the receiver is appointed, and it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies, and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. This, not because the creditors to whom such debts are due have in law a lien upon the mortgaged property or the income, but because, in a sense, the officers of the company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders; and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which comes into its own hands as, if practicable, to restore the parties to their original equitable rights. While, ordinarily, this power is confined to the appropriation of the income of the receivership and the proceeds of moneyed assets that have been taken from the company, cases may arise where equity will require the use of the proceeds of the sale of the mortgaged property in the same way. Thus it often happens that, in the course of the administration of the cause, the court is called upon to take income which would otherwise be applied to the payment of old debts for current expenses, and use it to make permanent improvements on the fixed property, or to buy additional equipment. In this way the value of the mortgaged property is not unfrequently materially increased . . . . Under such circumstances, it is easy to see that there may sometimes be a propriety in paying back to the income from the proceeds of the sale

> what is thus again diverted from the current debt fund in order to increase the value of the property sold. The same may sometimes be true in respect to expenditures before the receivership. No fixed and inflexible rule can be laid down for the government of the courts in all cases.

Id. at 253-54. The Court emphasized that the power to compensate for diversions from the "current debt fund" rests on the fact that mortgage creditors have "got possession" of what in equity belongs to all or some of the general creditors:

> It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion.

Fosdick's principle, then, is one of mortgage law: that the mortgagee's interest attaches to *net* income, which arises only after the payment from gross earnings for all necessary operating and managing expenses, proper equipment, and useful improvements, and that, in consequence, to the extent that before or during receivership bonded interest has been paid, additional equipment provided, or lasting and valuable improvements in the mortgaged property have been made out of earnings which ought in equity to have been used to pay debts for labor, supplies and the like, the receivership court can use receivership income or, in some cases, the proceeds of sale of the mortgaged property, to pay the debts that, but for the diversion of funds, would have been paid in the ordinary course of business. *Hale* v. *Frost*, 99 U.S. 389 (1879), was decided later in the same term on the authority of *Fosdick* but without discussion; it approved the payment from net income earned during the receivership of pre-receivership claims for repair parts to equipment and for supplies furnished to the railroad's machinery department. The report is silent concerning any "diversion" of earnings to the advantage of the mortgagee before or during the receivership.

Atkins v. *Petersburg R.R.*, *supra*, professed reliance on

Fosdick, but approved the re-payment from income of the receivership of an advance made before receivership to pay arrears of wages in order to avert a strike. There was no reference to "diversion." The court said that:

> . . . it would be difficult to draw a distinction between the principles under which a court authorizes a receiver to make necessary expenses for operating a railroad and keeping it in a safe condition, and the principles embodied in the language quoted from the opinion of the supreme court, relating to sundry expenses of the railroad companies incurred before the appointment of receivers . . . . It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

2 F. Cas. at 94. And in *Taylor* v. *Philadelphia & Reading R.R.*, *supra*, the court similarly cited *Fosdick* as justifying a broad order permitting payment from income of claims for "labor, materials, etc., furnished for the operation of the road within five months" preceding receivership, 7 F. at 377-78, and as authorizing the issuance of receiver's certificates for the amounts involved so that the receivers could defer payment in case they found it necessary to apply earnings to protect valuable investments of the railroad.

Miltenberger v. *Logansport, C. & S.W. Ry.*, 106 U.S. 286 (1882), did not cite *Fosdick*. The critical issues in the case related to the circuit court's action in authorizing substantial capital expenditures to be incurred, in giving them priority over the *first* mortgage in a suit brought to foreclose the *second* mortgage on the road, and in effecting payment for the capital expenditures through first lien receiver's certificates authorized and sold before the first mortgagees sought to foreclose. The Court cited only *Wallace* v. *Loomis*, 97 U.S.

146 (1878), the cornerstone case on receiver's certificates, and *Barton* v. *Barbour*, 104 U.S. 126, 136 (1881), which cited *Wallace* v. *Loomis* for the general proposition that a court of equity may and in most cases ought to authorize the receiver to keep the road in repair and to manage and use it in the ordinary way until it can be sold to the best advantage of all interested. *Miltenberger* approved the circuit court's order directing immediate payment of interline claims for materials, repairs, and ticket and freight balances, some of which had accrued more than ninety days preceding the receivership, and charging the payments upon the earnings of the road "as with a first lien prior to all incumbrances upon" the railroad. The Court pointed out that the receiver's petition for the order stated that "payment of that class of claims was indispensable to the business of the road, and that, unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." 106 U.S. at 311.[18] The Court said:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes out of the earnings of the receivership, or even the *corpus* of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with

[18] The master who passed on the claims "disallowed several items in the receiver's accounts, claimed under the above heads, where the claims were made on the ground that the creditors threatened not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311. The next sentence appears to refer to the master's action in disallowing the claims rather than to the receiver's action in paying them. "His action, sanctioned by the court, in allowing items within the scope of the orders of the court appears to have been careful, discriminating and judicious, so far as the facts can be arrived at from the record. It cannot be affirmed that no items which accrued before the appointment of a receiver can be allowed in any case." *Ibid.*

> very great care. The payment of such debts stands, *prima facie*, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances. It is easy to see that the payment of unpaid debts for operating expenses, accrued within 90 days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs, and for unpaid ticket and freight balances, the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

106 U.S. at 311-12. *Miltenberger* is concerned, not with the "diversion" precept of *Fosdick*, but with the more general authority of the receivership court to accord priority status to pre-receivership claims in order to prevent the stoppage of a business impressed with the public interest. The case emphasizes the power of the court to effect payment of pre-receivership claims and the validity of the means it chooses to effect payment; the analysis is not in terms of the property interest of operating expense creditors in operating revenues and the limitation of the mortgagee's rights to net income, but it is in terms of paying those pre-receivership expenses that are brought within the principle of administrative expenses by their relation to the continuance of the railroad business.

The cases in the Supreme Court involving payment of pre-receivership operating expense claims which were decided in the twenty-odd years between *Miltenberger* and *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), preserved the "diversion" principle expressed in *Fosdick* without losing sight of the separate *Miltenberger* approach. *Union Trust* v. *Souther*, 107 U.S. 591 (1883), allowed a pre-receivership supply claim on *Fosdick* "diversion" grounds; but the Court noted also that the receivership court's "right to impose terms does not depend alone on whether current earnings have been used to pay the mortgage debt, principal or interest instead of current expenses" (107 U.S. at 594), citing *Miltenberger*, and it indicated that the bondholders' election, in their own interest, to leave the loss-making company in possession to operate the road after there had been a default entitling the mortgage bondholders to take possession justified the court's use of receivership income to pay the expenses of pre-receivership operation.[19] *Burnham* v. *Bowen*, 111 U.S. 776 (1884), approved the payment of claims for coal furnished for the railroad's locomotives in the months preceding receivership. The Court emphasized that the bondholders permitted the company to possess and manage the road after default and observed that the "maintenance of the road and the prosecution of its business were essential to the preservation of the security of the bondholders." 111 U.S. at 780. In *Burnham* the order appointing the receiver did not provide for the payment of pre-receivership operating expenses; however, the Court held that the use of receivership income to pay fixed charges on certain railroad structures, increasing the bondholders' security

[19] *Union Trust Co.* v. *Walker*, 107 U.S. 596 (1883), decided with *Souther*, held that a purchaser of claims of "six months" creditors could enforce the claims, not because the creditors had a lien on the property and income but "because in equity the earnings of the company constitute a fund for the payment of the expenses which their claims represent, before any income arises which ought to be applied to the discharge of the mortgage debt." 107 U.S. at 596.

at the expense of the labor and supply creditors, was a "diversion" within *Fosdick*. "So far as current-expense creditors are concerned, the court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made." 111 U.S. at 782. The Court in *Union Trust Co.* v. *Illinois Midland Ry.*, 117 U.S. 434 (1886), was primarily concerned, as in *Miltenberger*, with the validity and priority of receiver's certificates, but it affirmed the grant of priority in the corpus of the property over the bonds for wages due for the six months preceding receivership. 117 U.S. at 464-65. To an objection that the order appointing the receiver provided only for payment of current operating expenses from current income the Court answered that "the terms of these orders do not impair or exclude the ample authority which the court would otherwise have, and otherwise has, to order the claims in question to be paid out of the property itself, with priority." *Id.* at 465. *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355 (1898), affirmed a decree directing that a debt for locomotive coal delivered in the months preceding receivership be paid out of the current earnings in the hands of the receiver; the Court relied on language from *Burnham* v. *Bowen*, *supra*, and *Miltenberger*, as expressing an "equitable doctrine" the "dominant feature" of which was that a "superior equity" as against the mortgage bondholders, in income earned before and after the receiver's appointment, arises in favor of materialmen who furnish supplies essentially necessary to the continued operation of the railroad in the expectation of payment from current earnings. 170 U.S. at 367-68. The Court emphasized that, independently of the existence of any pre-receivership "diversion" of income, the equity of the coal company for payment out of income survived into the receivership, attached to the property in the receiver's possession, and, if a surplus of income arose in the receivership, entitled the coal company to demand that the

surplus be applied to payment of its claim. *Id.* at 369. The existence of that surplus the court found implicit in the fact that during receivership the road's receivers "expended for betterments on its railroad lines from the income of the roads during the receivership a sum much larger than the entire claim" of the coal company. *Id.* at 367-70. *Southern Ry.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900), affirmed a decree according priority payment for rail furnished during a period in excess of six months preceding receivership; the Court inferred that the rail was furnished for ordinary safe maintenance of existing lines;[20] the Court found that current receipts that should have been applied to payment of the steel company's claim had been applied during the receivership for the benefit of the bondholders by paying interest, sinking fund, and car trust debts and for construction and equipment.

Circuit court decisions, influenced by *Miltenberger*, clearly went beyond the *Fosdick* principle. *E.g.*, *Dow* v. *Memphis & L. R.R.*, 20 F. 260, 267 (C.C.E.D. Ark. 1884); *Blair* v. *St. Louis, H. & K. R.R.*, 22 F. 471, 472-73 (C.C.E.D. Mo. 1884). One case, in the Fourth Circuit Court of Appeals, in which Chief Justice Fuller wrote for the court, allowed the payment from the proceeds of the foreclosure sale of the road of interline claims for freight and freight balances that accrued before the appointment of the receiver. *Finance Co.* v. *Charleston, C. & C. R.R.*, 62 F. 205 (4th Cir. 1894). There were no surplus earnings before or during the receivership, nor had there been any diversion of income. The court relied on the broad terms of the order appointing

[20] A claim for extraordinary quantities of rails furnished before the receivership but outside the ordinary course of business, and for construction rather than repair, was not accorded priority. *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 315-16 (1900); *Hale* v. *Frost, supra*, disapproved priority payment for pre-receivership supplies furnished to the road's construction department while approving such payment for repair parts and for supplies so furnished to the road's machinery department.

the receiver, saying that it could not be construed as limited to payment out of current earnings, "especially in view of the condition of the road." 62 F. at 208. Emphasizing that the payment of such debts was related to the interest in preserving and disposing of the property as a going concern, and to the interest in the road's discharging its public duty, the court said that

> . . . such indebtedness may be given priority, notwithstanding there may have been no diversion of income, or that the order for payment was not made at the time, and as a condition, of the receiver's appointment, the necessity and propriety of making it depending upon the facts and circumstances of the particular case, and the character of the claims.

62 F. at 208.

The Supreme Court did not sweep so broadly. *St. Louis, A. & T. H. R.R.* v. *Cleveland, C.C. & I. Ry.*, 125 U.S. 658 (1888), acknowledged the authority of *Fosdick*, but it refused to accord priority over the mortgage to a claim for the rental of a leased line. The Court said that the lessor would have to show that the rent arrearage had arisen "by the diversion and misappropriation of the fund that ought to have been applied to its payment to the use and benefit of the mortgage bondholders." 125 U.S. at 674. To the extent that the Court impliedly required a showing of diversion before the receivership, it appears to be repudiated in *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, 170 U.S. at 365, 369. *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89 (1890), was a case in which there were no surplus earnings before or during the receivership, no receipts were diverted to pay mortgage interest or to improve the road, and the foreclosure sale realized only a fraction of the mortgage debt; the Court held that an unpaid conditional vendor of rolling stock, whose cars were ordered returned to him before the foreclosure sale, would not be granted a priority claim for the reasonable

rental value of the cars used during the four months of their use by a receiver appointed upon a *judgment creditor's bill*, but that such a priority would be accorded to the claims for reasonable rent for use of the cars by a successor receiver appointed at the end of the four months upon the *mortgage trustee's foreclosure bill*. The Court was critical of "an idea" which "seems to have obtained that a court appointing a receiver acquires power to give such preference [that is, preference over mortgage debts] to any general and unsecured claims." 136 U.S. at 97. But in the same year the Court in *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, 137 U.S. 171, 197 (1890), although denying priority to the claim before it, broadly restated both the *Fosdick* principle and that of *Miltenberger*. And *Kneeland* v. *Bass Foundry & Machine Works*, 140 U.S. 592 (1891), distinguished *Kneeland* v. *American Loan & Trust Co.*, *supra*, on its facts and as relating to a contract to buy rolling stock in which the vendor reserved title and reclaimed the rolling stock;[21] the Court in *Bass Foundry* affirmed an order for payment of claims for supplies furnished during the four month period for which the earlier *Kneeland* decision had rejected the reasonable rental value claim; the Court relied on *Fosdick* and *Miltenberger* and on *Union Trust Co.* v. *Souther*, *supra*. *Thomas* v. *Western Car Co.*, 149 U.S. 95 (1893), again rejected a car vendor's claim for a reasonable rental for the pre-receivership months and cited *Kneeland* v. *American Loan & Trust Co.*, but it put the decision in large part on the ground that the terms of the contract for the cars demonstrated that the vendor relied on the security of the cars themselves and not on the interposition of a court of equity.[22] 149 U.S. at 112. Similarly,

[21] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, distinguished *Kneeland* v. *American Loan & Trust Co.* on essentially the same ground. 170 U.S. at 370-71.

[22] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.* *supra*, treated *Thomas* as decided on the ground that the car company relied on the responsibility of the railroad company and not on the interposition of a court of equity. 170 U.S. at 371-72.

Penn v. *Calhoun*, 121 U.S. 251 (1887), and, later, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298 (1900), rejected priority claims where, in the first case, the creditor took as security bonds of the railroad for twice the amount of the claim, and, in the second, the creditor had taken collateral security for part of the debt and had extended and renewed long terms of credit; in neither case could it be found that the creditor relied on the railroad's current earnings for payment.

Gregg v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), dealt with Gregg's claim for railroad ties delivered to the railroad in the month preceding the receivership; they were used principally during the receivership to maintain the railroad as a going concern, and the claim for payment was admittedly for a necessary operating expense incurred to keep and use the railroad and preserve the property in fit and safe condition. There had been no diversion of income by which the mortgagee had profited, or otherwise, and, the Court concluded, the circumstances affecting the claim were not "special." The Court said that the claim could not be charged on the *corpus* of the fund unless there was

> . . . a general rule that such claims for supplies are entitled to precedence over a lien expressly created by a mortgage recorded before the contracts for supplies were made.

197 U.S. at 186-87. The Court said that

> . . . we are of opinion, for reasons that need no further statement, *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89, 97, that the general rule is the other way, and has been recognized as being the other way by this court.

197 U.S. at 187. Of the allowance of pre-receivership claims in *Miltenberger*, the supplier's principal reliance, the Court said:

> The ground of such allowance as was made was not merely that the supplies were necessary for the preservation of the road, but that the payment was necessary to the business of the road — a very different proposition.

Ibid. Other cases were distinguished as related to the special principle of *Miltenberger*, or as involving diversion of earnings, and cases like *Union Trust Co.* v. *Souther*, *supra*, where the receivership order authorized payment of six months claims for labor and supplies out of income, were explained as standing

> . . . on the special theory which has been developed with regard to income, and afford no authority for a charge on the body of the fund.

Id. at 188. The cases the Court cited as developing the "special theory" with regard to income are *Fosdick*, *Burnham* v. *Bowen*, *supra*, *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, *supra*, *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, and *Southern Ry.* v. *Carnegie Steel Co.*, *supra*. The Court added:

> It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver, but that question is not before us here.

Ibid. The original receivership order in *Gregg* authorized the receiver to pay material and supply claims which accrued not more than six months before the receivership. Of this provision the Court said:

> But even if any words in the order authorized a charge on the corpus in order to pay claims like that of the petitioner, or a payment of them except from income, certainly there are none requiring it, or going beyond giving authority to the receiver if, for instance, he thought payments of previous debts necessary to the continued operation of the road.

Id. at 188-89.

Gregg is the last extended opinion on the Six Months Rule, and on the Necessity of Payment rule in the Supreme Court.[23]

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[23] *Baker* v. *Gold Seal Liquors, Inc.*, 417 U.S. 467, 471 n. 5 (1974), refers to the priority language of Section 77(b), to *Gregg* as to that priority, and to *St. Louis & S.F.R.R.* v. *Spiller*, 274 U.S.

The dissent clearly states the more inclusive principle that the Court's majority seemed to reject:

> And that principle has its foundation in the public interests. A railroad, from its nature and public responsibilities, must be kept a going concern. This is the supreme necessity, and affords the test of the equity invoked for the claims for supplies. It cannot depend upon diversion of income or upon the existence of income. It cannot be confined to debts contracted during the receivership. It may extend to debts contracted before the appointment of the receiver. But recognizing that there must be some limitation of time, the courts have fixed six months as the period within which preferential claims may accrue. And there is no infringement of the rights of mortgagees. Their interests are served, as those of the public are, by keeping the railroad in operation. The limitations of the rule dependent upon the conditions under which supplies are furnished are expressed in *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355, and in *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 257.

Id. at 196.

Carbon Fuel Co. v. *Chicago, C. & L.R.R.*, 202 F. 172 (7th Cir. 1912), a case in which there was neither surplus earnings nor any diversion of income, interpreted *Gregg* as limiting *Miltenberger* to the cases in which not the supply or service furnished to the railroad but *payment* by the receiver is essential to the continuance of the business of the railroad. *See*, to the same effect, *Taylor* v. *Delaware & E.R.R.*, 213

304, 311 (1927), as stating the general six months limitation on *Fosdick* claims. *New York Dock Co.* v. *S.S. Poznan*, 274 U.S. 117, 121 (1927), stated the *Fosdick* principle as requiring payment for supplies furnished before receivership where the debtor's or receiver's use of them "has produced the earnings;" the Court considered the result to flow from the courts' self-imposed duty to require that, before distribution, expenses that have contributed to the preservation or creation of the fund in its custody should be paid.

F. 622, 624 (2d Cir. 1914), *Moore* v. *Donahoo*, 217 F. 177, 180-83 (9th Cir. 1914), *cert. denied*, 235 U.S. (1915), *Chicago & A.R.R.* v. *United States & Mexican Trust Co.*, 225 F. 940, 945 (8th Cir. 1915), and *Crane Co.* v. *Fidelity Trust Co.*, 238 F. 693, 695-96 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917).

Pennsylvania Steel Co. v. *New York City Ry.*, 216 F. 458, 470 (2d Cir. 1914), however, referred to *Gregg* as the "most striking example of the uncertainty which surrounds the whole subject." The Court allowed pre-receivership supply claims against unmortgaged assets of the railway in the absence of any "current debt fund." The court said:

> If the preference is properly rested on public policy we do not see how it can be restricted to current earnings. Such claimants should be preferred over all general creditors, and if current earnings are not sufficient to secure the preference it should be extended to the company's unmortgaged assets.

216 F. at 471. *Johnson Fare Box Co.* v. *Doyle*, 250 F.2d 656, 657 (2d Cir.), *cert. denied*, 357 U.S. 938 (1958), paraphrased with apparent approval, a district court's assertion[24] that it is very difficult to discover any principle which would account for all the decisions, and that the only generality obtainable from the cases is that the decision in each depended on its special facts.

Southern Ry. v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962), rejected the theory that *Gregg* severly limited *Miltenberger*, 301 F.2d at 852, and emphasized that, from *Miltenberger* forward, "public concern with the continued operation of the railroad has been a factor supporting the priority accorded

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[24] *In re Third Avenue Transit Corp.*, 138 F. Supp. 623 (S.D. N.Y. 1955), *aff'd on opinion below*, 230 F.2d 425 (2d Cir. 1956). *Third Avenue Transit* treated pre-receivership operating expense claims as enjoying priority only in net income of the railroad and of the receiver.

general creditors." *Id.* at 853.[25] The court accorded interline traffic balances and other interline accounts a priority in corpus over the mortgage bondholders. The court treated the time limitation, generally six months, as preventing operating claims from undermining the mortgage through secret liens. *Ibid.*

In re New York, N.H. & H. R.R., 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969) ("*New Haven*"), saw the Six Months Rule as one that over the years had been inconsistently stated and applied in decisions that lacked any harmonizing principle, so that "ambiguities must generally be resolved against those claiming the benefit of the rule." 278 F. Supp. at 595-96. The rule of *Fosdick* was summarized:

> Revenues accruing from operations should be paid first to the operations creditors whose materials and services made those revenues possible; and only after all such operational claims have been paid, should the balance be available for the benefit of the mortgagees. If any operating revenues do improperly get into the hands of the mortgagees, equity requires that those revenues be restored to the operations creditors by the mortgagees yielding them a priority. (Footnote omitted.)

278 F. Supp. at 597-98. The "surplus earnings" element of the "current debt" or "expense" fund of *Fosdick* the court defined as the sum of all operating revenues accrued during the six months period and during reorganization and which have actually been received or taken over by the trustee less depreciation and all operating expenses that have actually

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[25] The court noted its earlier statement in *Virginia Passenger & Power Co.* v. *Lane Bros.*, 174 F. 513, 516 (4th Cir. 1909), that in certain cases preferential payments have been allowed out of corpus. "One of the foundations of the principle is that the public interest requires that a railroad must be kept a 'going concern.' It does not depend, therefore, upon the diversion, or even upon the existence of income."

been paid, or are payable by the trustee, or which constitute administrative expenses.[26] *Id.* at 599. In *New Haven* the court found neither "surplus earnings," as it defined them, nor "income available for fixed charges," nor unmortgaged assets, nor any diversion to the mortgagees' advantage of current revenues to which the operations creditors were entitled, since neither the depreciation allowances nor payments on equipment trust and conditional sales obligations could be considered such diversions. *Id.* at 600-05. The court concluded that the six months creditors could not be accorded a priority in corpus over the mortgage bondholders. The court considered that *Flournoy* had confused and merged the Six Months Rule and the Necessity of Payment rule, "first enunciated in *Miltenberger*," by making necessity of payment a requirement of the Six Months Rule and eliminating diversion as a requirement of corpus invasion," directly contrary to *Gregg*. *Id.* at 602 n. 15. The court, on the supposed authority of *Gregg*, reduced *Miltenberger* to the case in which immediate payment is necessary to avert a threat to continued operation of the road, and characterized as "absurd" reliance on the Necessity of Payment rule by creditors whose claims had gone unpaid during six years of operation in reorganization. *Id.* at 602-03 n. 15.[27]

In re Tennessee Central Ry., 316 F. Supp. 1103 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972), accorded a

[26] The court differentiated its treatment of the six months earnings ("gross operating income" taken over and collected by the trustee less expense items payable on the date the petition was filed which the trustee was required to pay) from the scheme referred to in *Guaranty Trust Co.* v. *Albia Coal Co.*, 36 F.2d 34, 36 (8th Cir. 1929), that is, "gross operating income taken over or collected by the receiver less taxes accrued." 278 F. Supp. at 599.

[27] The Court of Appeals affirmed, 405 F.2d 50 (2d Cir. 1968), saying that the "current expense fund" for six months claims "is to be computed by deducting operating expenses and depreciation from current revenues." 405 F.2d at 52.

priority over mortgage bonds to claims for interline freight balances; the court found that the extensions of credit that the balances reflected averted a complete shutdown of the railroad's operation and facilitated the sale of the railroad to three other carriers which continued to operate it. The court relied in part on the special character of interline freight balances as collections for which the road had to account to connecting carriers, 316 F. Supp. at 1110, and ultimately on the circumstance that the connecting carriers' extension of credit preserved the corpus of the mortgaged railroad by maintaining it as a "going concern" and enabled the area formerly served by the railroad to enjoy continued rail services. *Id.* at 1111. The court argued that *Gregg* seemed to indicate that, where special circumstances or equities favored six months claimants, their claims might be allowed a priority in assets even in the absence of a diversion of income to the secured creditors' benefit. *Ibid.*

In re Penn Central Transp. Co., 458 F. Supp. 1234, 1319-28 (E.D. Pa. 1978), relied principally on *New Haven* as a distillation of a large number of earlier cases; the "current debt fund," the court said, included surplus income of the six months preceding reorganization as well as for the reorganization period, inclusive of non-rail income customarily made available to support rail operations; generally accepted railroad accounting principles were held applicable, depreciation being deducted from operating revenues in computing the "current expense fund." The deficit in Penn Central's income for the six months period and during reorganization exceeded the depreciation for the same period by very much more than the aggregate of the six months claims; since there was no earnings component for the *Fosdick* "current debt fund," and capital improvements for the same period (nearly four times the amount of the six months claims) were far less than the depreciation for the period, the court concluded that there

was neither enhancement of property nor "diversion."[28] 458 F. Supp. at 1325. The court rejected *Flournoy* as "discredited" and as impermissibly combining the six months and necessity rules, and treated the Necessity of Payment rule as stating the circumstance in which a court could justify entry of an order authorizing payment of a pre-reorganization creditor who invoked the sanction of refusal to furnish further supplies or services as a means of obtaining payment of his old claim.[29] *Id.* at 1326-27.

B.

The persistence of the Six Months Rule and the persistence of two distinct attitudes toward it, the one receptive and

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[28] The trustee evidently argued that $770 million spent on capital improvement should not be considered in the "diversion" calculation because the expenditure did not exceed the *increase* in depreciation reserve through charges to income in the period. The six months creditors apparently argued that this was "double dipping," taking depreciation into account twice, once to compute surplus earnings and a second time to absorb the capital expenditures' effect as a diversion to the advantage of the mortgage bondholders. The court sought to meet the argument with the statement that, if the amount of depreciation charged had actually been spent to make good the depreciation, that outlay "would not thereby have enhanced the mortgaged assets at the expense of the six months claimants." 458 F. Supp. at 1375. That, however, is, logically, a restatement of the conclusion that depreciation should be deducted in computing the earnings component of the *Fosdick* "current debt fund." The court met the argument directly by concluding that even adding back the depreciation did not produce *Fosdick* surplus earnings, leaving the capital expenditures in large part unexplained, however. *Ibid.*

[29] The court said that *In re Penn Central Transp. Co.*, 467 F.2d 100 (3d Cir. 1972), correctly stated the Necessity of Payment doctrine. The appellate court summarized the Necessity of Payment rule, an "exception to the normal deferment of payment of pre-reorganization claims until their disposition can be made part of a plan of reorganization," as permitting immediate payment where creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims are paid. 467 F.2d at 102 n.1. The appellate court intimated that a reorganization court might well have power to compel a continuance of a service sought to be withheld in order to coerce payment of an old claim. *Id.* at 102.

expansive, the other insistent upon its limitations and narrow sphere of operation, suggest the co-existence of two essentially different principles, neither of which limits the operation of the other, and both of which may operate in the same reorganization to embrace many of the same claims. The *Fosdick* rule is one of equitable restitution; in receivership the mortgagee must restore to operating creditors revenues diverted to the mortgagee's advantage; the lien of the mortgage extends to railroad revenue or income only when possession of the road and its income is demanded, pursuant to the mortgage terms after default, *Fosdick, supra*, 99 U.S. at 253; *Gilman* v. *Illinois and Mississippi Telegraph Co.*, 91 U.S. 603, 617 (1876); *Galveston, H. & H. R.R.* v. *Cowdrey, supra*, 78 U.S. (11 Wall.) at 482-83, and the lien reaches only what remains of revenue after payment of all current operating expenses. *Burnham* v. *Bowen, supra*, 111 U.S. at 782-83. The receivership furnishes the occasion and judicial means of effecting the equitable restitution, but mortgage law, not the special principles governing the administration of railroad receiverships, is the source of the right to restitution.

The second rule, elaborated and applied in *Miltenberger*, is peculiarly a principle of railroad receivership law, reflecting the view that a "railroad is authorized to be constructed more for the public good to be subserved, than for private gain . . . . It is . . . a matter of public right by which the courts, when they take possession of the property, authorize the receiver . . . in whose charge it is placed to carry on in the usual way those active operations for which it was designed and constructed, so that the public may not receive detriment by the non-user of the franchises." *Barton* v. *Barbour*, 104 U.S. 126, 135 (1881). *Miltenberger*, relied on *Wallace* v. *Loomis, supra*, 97 U.S. at 162-63, for the authority to issue receiver's certificates superior to the first mortgage lien to finance the payment of pre-receivership operating expenses, administrative expenses of the receiver and costs of new

construction, and relied on *Barton* v. *Barbour* for the public interest justification for continued operation of the railroad as a going business. 106 U.S. at 309-12. The Court said that payment of pre-receivership debts

> . . . where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

Id. at 312. The Court's rationale excludes the inference that only those creditors are entitled to priority of payment who demand immediate payment as a condition of continuing to supply a service or commodity of which they are monopolists.[30] The Court was defining the *classes* of claims payment of which was indispensable to the business of the road and which, "unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." *Id.* at 311. The Court's depiction of the disastrous consequences of failing to pay labor claims — a work stoppage[31] — or interline claims — a stoppage of traffic interchange — is directed to restricting the class of claims entitled to priority of payment to claims for those goods and services that are

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[30] As noted above, footnote 18, the special master disallowed "several items" where the claimants threatened "not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311.

[31] In *Skiddy* v. *Atlantic, M. & O. R.R.*, *supra*, 22 F.Cas. at 281-82, the court, acting on such a ground, directed the receiver to pay eight months back wages to those employees only who continued in employment; claims of the remaining employees and claims for materials supplied under contracts made on the eve of receivership were denied priority. The district judge who joined in the *Skiddy* opinion evidently regarded it as overruled in its latter aspect by *Fosdick*. *Atkins* v. *Petersburg R.R.*, *supra*, 2 F. Cas. at 92.

indispensable to the continued performance of the transportation service. The point is to single out the pre-receivership expenses the payment of which although it — *prima facie* — may stand on a different principle from that governing payment of administrative expenses, "may be brought within the principle of the latter by special circumstances." *Ibid.* The test is not whether the claimant has the naked power to exert economic duress, but whether the expenses have the characteristics of those that the receiver pays from revenue as expenses of administration or pays out of the proceeds of the sale of first lien receiver's certificates. *E.g.*, *Boston & Maine Corp. Trustee's Competitive Bidding Exemption*, 347 I.C.C. 234, 235 (1971). (Sale of certificates "for meeting payroll and other expenses which, if not met, would preclude continued provision of essential railroad transportation services.") An early district court decision, authorizing the issuance of receiver's certificates, summed up the principle:

> It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

Atkins v. *Petersburg R.R.*, *supra*, 2 F. Cas. at 94.

Some decisions have, very evidently, read *Gregg* as reducing *Miltenberger* to a Necessity of Payment holding in the starkest economic duress form,[32] but *Gregg* is, rather, circumspect in

[32] With one exception, later cases in the Supreme Court that cited *Miltenberger* relied also on the equitable restitution principle of *Fosdick*. *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, 170 U.S. at 365-66; *Illinois Midland Ry.*, *supra*, 117 U.S. at 456-58; *Union Trust Co.* v. *Souther*, *supra*, 107 U.S. at 594. The exception is *Kneeland* v. *Bass Foundry & Machine Works*, *supra*, 140 U.S. at 596-97, where the claim was ordered paid out of corpus because the supplies covered by the claim "had been necessary to the continued operation of the road, and had gone into the general property covered by the mortgage" and "contributed to the preservation of the property during the receivership." Neither a surplus of earnings nor a diversion was involved.

its treatment of *Miltenberger;* it preserves the ambiguity of the *Miltenberger* language without explaining or applying it, and declines to find that Gregg's facts presented special circumstances warranting priority. The Supreme Court has since cited *Miltenberger* for the principle that claims with equities superior to the mortgagee's "may be accorded priority in payment although they arose prior to the receivership." *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940).

The criterion of priority to have intrinsic validity must be found in the nature of the claim and in the nature of the reorganization. If the claim is for a service or supply indispensable to the maintenance and operation of the railroad, and if the railroad continues to operate while in reorganization, the real difficulty is in finding a ground on which a court can fairly deny payment of a pre-reorganization expense claim indistinguishable from current administration expenses that are being paid and indistinguishable from kindred operating expenses that were incurred in the ordinary course of business by the railroad company in the months preceding reorganization and were paid by the railroad before reorganization or were paid thereafter by the trustees as liabilities arising out of the operation of the railroad. If a claim has the generally accepted characteristics of a six months claim, as stated in the district court's opinion, 468 F. Supp. at 1002, that is, (1) it represents a current operating expense necessarily incurred, (2) was incurred within six months before the reorganization petition was filed, and (3) the goods or services were delivered in the expectation that they would be paid for out of current operating revenues of the railroad, and not in reliance on the road's general credit,[33] it will inevitably be for an expense indistinguishable from and essentially contemporaneous with

[33] To the same effect are *In re Penn Central Transp. Co., supra,* 458 F. Supp. at 1321; *In re New York, N.H. & H. R.R., supra,* 278 F. Supp. at 596; *Guaranty Trust Co.* v. *Albia Coal Co., supra,* 36 F.2d at 35.

expenses paid by the railroad before reorganization, and will be indistinguishable from currently paid administration expenses. The singularity of the claim will not be either in the goods or services which it represents, nor in their contribution to the railroad's service to the public, nor in their contribution to the preservation of the fabric of the railroad, but only in the fact that it will, of course, not be paid. No principle marks current expenses paid in ordinary course on the eve of reorganization as preferences, but denial of an equivalent right to priority payment for expenses of the same kind likewise incurred on the eve of reorganization introduces an inequality of treatment that finds no justification either in the principles on which businesses are continued in operation during receivership, or in the mortgagee's lien interest. The desideratum is equality of treatment for the current operating expenses of a railroad enterprise the operations of which have continued without interruption of service, revenues and expenses. That equality is readily achieved by recognizing administration expenses as extending backward to the period preceding reorganization to the extent necessary to assure that there is continuity in the payment of indispensable operating expenses without reference to the date the petition is filed so long as the current expenses of the pre-reorganization period that are brought forward for payment conform to the strict standard established for administration expenses of the current operating class, and are not so dated as to forbid the conclusion that they are in fact current. The inequity in treatment arising out of the accidental circumstance of non-payment before the filing of the petition is eliminated.

The hostility to "six months" claims evident in *Gregg*, *supra*, 197 U.S. at 186-87 and *New Haven*, *supra*, 278 F. Supp. at 596,[34] is no doubt in some part a product of the

[34] In contrast is the support for a broad receivership principle approach successively evident in *Finance Co.* v. *Charleston C. & C. R.R.*, *supra*, 62 F. at 208, the dissent in *Gregg*, *supra*,

uncertain limits of the class of claims: six months is not an inflexible time limit, and each case "must depend largely upon its special facts," *Southern Ry.* v. *Carnegie Steel Co.*, *supra*, 176 U.S. at 292; the "surplus earnings" and the quantum of "diversion" relevant under *Fosdick* are puzzling concepts, *id.* at 294-95; *In re Penn Central Transp. Co.*, *supra*, 278 F. Supp. at 598-601; reliance on the general credit of the railroad seems an illusory concept, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 316-17 (1900) (security taken upon renewal of notes given for rail); *Southern Ry.* v. *Carnegie Steel Co.*, *supra*, 176 U.S. at 292 (if first notes given for rail contemplated payment from current earnings, seller "lost no equity merely by renewing the notes"); *Penn* v. *Calhoun*, 121 U.S. 251, 252 (1887) (bank took bonds of railroad to secure repayment of loan). But the definition of the class has been left to the courts by the Congress,[35] and when

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197 U.S. at 196, and *Flournoy*, *supra*, 301 F.2d at 851-52. The paragraph by which Chief Justice Waite introduced the discussion of priorities in *Fosdick*, *supra*, 99 U.S. at 251-52, is more easily referred to the broad receivership principle later elaborated in *Miltenberger* than to the narrow principle of equitable restitution that the following paragraphs of the opinion outline.

[35] The Commission on the Bankruptcy Laws of the United States, Report, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* King, Klee and Levin, Collier on Bankruptcy (15th Ed.), Appendix, Vol. 2, Part I, p. 270, recommended retaining the "so-called six-month priority rule according to creditors who supplied necessities to the debtor within six months prior to the filing of the petition the status of administrative expense claimants." The Commission's recommended bill, in the "Confirmation of Plan" section (9-503), included a requirement that the plan provide "for payment of all allowed claims for current operating expenses incurred by the debtor during the six months immediately preceding the filing of the petition." *Id.*, Part I, p. 288. The Senate in 1978 would have followed the Commission recommendation to provide that "traditionally accorded" priority (S. Rep. No. 95-989, 95th Cong., 2d Sess. 135-36, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5921-22), and S. 2266, 95th Cong., 1st Sess. § 1173(a) (9) (1978), required that the "Plan" include a provision for payment in cash of all allowed claims for current operating expenses during the six months preceding the filing of the petition. The House Bill, H.R. 8200,

the time comes to determine membership in the class[36] it will be for the reorganization court to determine what claims belong in the class because they represent indebtedness for ordinary and necessary current operating expenses indispensable to continued rail service of the kinds being paid currently as expenses of administration; whether the non-payment reflects an intentional extension of credit to the railroad, or the intervention of the reorganization petition before expiration of the ordinary billing and payment period, or some non-contractual indulgence or inadvertence on the part of the claimant, or deferment of payment on the part of the railroad; and whether, if the transaction giving rise to the claim had any credit term, it was compatible with a general expectation of payment from current receipts or indicated reliance on the railroad's general credit. In any event, it must be concluded that the class of creditors entitled to the priority contemplated by Section 77(b), 11 U.S.C. § 205(b) (1976), is not limited to participation in the current debt (expense) fund defined in terms of *Fosdick* equitable restitution, but extends to participation in reorganization railway operating revenues essentially on the same basis as administration expenses incurred during the reorganization period.

C.

Where payment for pre-reorganization services and supplies is claimed on the ground that the expenses are within

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95th Cong., 1st Sess. (1977), which in substance proposed to continue, as Section 1170(b), the language of former Section 77(b), and H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 424, *reprinted in* [1978] U.S. Code Cong. & Ad. News 6380, stated that "As under current law, the courts will determine the precise contours of the priority recognized by this subsection in each case." The provision enacted as 11 U.S.C. § 1171(b) follows the House Bill and substantially continues the language of Section 77(b).

[36] Since the district court disposed of the six months claims on the ground that there was no current debt fund, 468 F. Supp. at 1003, and no diversion, *id.* at 1004-06, and did not designate a priority classification for six months creditors, *id.* at 1008, the court did not refine its definition of the class, *id.* at 1002, nor set out the limitations on membership in such a class.

the principle governing the priority accorded to administration claims, questions respecting the existence of a current expense or debt fund, that is, of surplus earnings or net income, are not directly involved; the controlling considerations are those taken into account in authorizing administration expenses.

However, if payment is claimed under the *Fosdick* principle, the existence of a current debt fund must be demonstrated. The district court's analysis of the financial data, 468 F. Supp. at 1002-04, 1005-07, establishes that there were no surplus revenues but a deficit in operating income and income available for fixed charges in the period from September 13, 1969, to July 31, 1978, and that the operating deficit exceeded the amounts arguably expended to the mortgagee's advantage. However, in its analysis the district court defined the earnings (deficit) component of the current expense fund as comprising revenues less operating expenses *and depreciation*, *id.* at 1003; the court rejected the argument that providing an allowance for depreciation out of revenue enhanced the mortgaged assets and so was a diversion, *id.* at 1006-07; it indicated approval of the *New Haven* view that depreciation reflects the consumption of the railroad property through use, and that the depreciation allowance is comparable to expenditures made merely to preserve and not to increase the mortgaged assets. *Ibid. See New Haven*, *supra*, 278 F. Supp. at 604; *In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1324-25; note 28, *supra*.

Certainly the depreciation of income producing property, the exhaustion of its utility over the years of its useful life, is an objective fact.[37] It is, however, not related to ordinary

[37] When *Fosdick* was decided some railroads at least charged certain classes of additions and betterments to revenue, *see Union Pacific R.R. v. United States*, 99 U.S. 402, 420-22 (1879), and until the 1920s "retirement accounting" was common, that is, no annual depreciation charges were made against revenue, but when capital assets were retired their original cost was charged to revenue

repair and maintenance; it relates to the exhaustion of useful life despite regular repairs and maintenance. Depreciation is by its nature indelibly a capital charge, the cost, allocated to the accounting period, of the capital used to produce the revenue of that period. If the depreciation reserve is considered an accumulating fund, and not simply a record of the annual postings of fractions of the original capital cost, it is a fund accumulated to restore the original capital investment in money, or to provide a new capital asset. But the annual charges to revenue for depreciation of capital assets do not create a fund in specie that preserves the identity and stands in place of the depreciable asset and is subject to any mortgage that there may be on the asset. There is no suggestion that, here, the railroad did, or that, generally, railroads do undertake with their mortgage bondholders that they will use an amount equal to annual depreciation to make good — if that could be done — the physical depreciation of the mortgaged property. Something roughly like that may no doubt occur in good times as a portion of earnings each year is reinvested in the road, but such reinvestments are capital outlay for new assets themselves depreciable, and that the new investments may not exceed the depreciation charges of the same period means only that — assuming constant prices — the road is losing old capital values through use faster than it is acquiring new capital assets. In good times new capital assets acquired will often, perhaps usually, come under the after-acquired property clauses of the mortgage, and the long term mortgagee

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in the year of retirement. *See Depreciation Charges of Telephone Companies*, 118 I.C.C. 295, 302-03, 305-07 (1926) (outlining railroad practices and position); *Illinois Central R.R.* v. *I.C.C.*, 206 U.S. 441, 461-63 (1907); *cf. Kansas City Southern Ry.* v. *United States*, 231 U.S. 423, 445-48 (1913) (railroad arguing unsuccessfully that, where new roadbed and track replaced short section of old roadbed and track in order to improve grade and speed and reduce cost of service, the abandonment cost of the old track did not have to be charged to revenue).

will have a kind of slowly revolving security.[38] But first to last depreciation is related to capital, its exhaustion, and its replacement, not to its maintenance, and it is not an expenditure that affects cash flow of the accounting period.

The Boston and Maine accounts recorded an aggregate net railway operating loss in the period September 13, 1969, to December 31, 1977, of $42.5 million, and of that $33.2 million represented charges for depreciation. That amount could not represent a diversion of revenues to the mortgagee's advantage for the all-sufficient reason that it was not a current expenditure in any sense. If in the same period revenues were used for capital expenditures and to retire secured obligations (*supra* page 12), they were so used whether or not depreciation charges were made, and they had the special significance that *Fosdick* attaches to such expenditures, quite without reference to the amount of depreciation currently charged. *Fosdick* is concerned with the priority in operating revenues owed to current operating expenses. To rank depreciation charges equally with current operating expenditures in their claim upon revenue is to reject the priority that *Fosdick* recognized. The mortgage does not extend to the assets plus the depreciation reserve built up over the years against the assets, but only to the wasting asset itself. When in receivership the *Fosdick* principle intervenes, the priority of current operating expenses in revenue precludes any deferment to depreciation charges

[38] *Uniform System of Accounts for Railroad Companies*, 309 I.C.C. 289 (1959), approved the railroads' dispensing with retirement and depreciation accounting for track maintenance; observing that the useful life of the composite track structure is semipermanent in the sense that, when properly maintained, the end of its life span is unforeseeable, the I.C.C. concluded that no good purpose would be served by requiring retirement and depreciation accounting for track so long as the railroads continued to maintain existing track in proper condition through adequate replacement, as needed, of rails, ties, ballast and other material so that deterioration in track structure and impairment of the corporation's capital investment was avoided. 309 I.C.C. at 292, 296. Track maintenance illustrates the revolving security concept.

that, if allowed in the *Fosdick* calculation, would be a direct set-aside of revenue for the mortgage bondholders at the cost of the current-expense creditors. No ground exists for allowing depreciation in a *Fosdick* calculation of earnings that would not as a logical corollary require trustees' certificates to share their lien rank with the sum of the depreciation allowances recorded since March 12, 1970, for, in the ultimate sense, trustees' certificates, to the extent that they do not rest on "free assets," are a charge on the revenues from which expenses of administration, in considerable part current operating expenses, are paid.

D.

The district court rejected the appellants' contention that the Necessity of Payment rule is a rule of priority and accepted the conclusion of *New Haven*, *supra*, 278 F. Supp. at 603 n. 15, that the rule is not based on considerations of equity but is a device for handling a threat to the continued operation of the railroad *during reorganization*. 468 F. Supp. at 1008. To the extent that a strict necessity of *payment* rule has developed from the cases it would not be a rule conferring a right of recovery on the claimant but a rule of exculpation, protecting the trustee who paid under economic duress for a supply or service indispensable to continued operation of the railroad. *See In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1326 ("By definition, the necessity of payment rule is one to be invoked by Trustees, as justification for their decision to pay these unsecured pre-bankruptcy claims.") Under this distinct rule the district court was clearly right in its conclusion that, since no creditor claiming under that rule had insisted on payment of its claim as a condition of providing goods and services to the debtor, and since the trustees had never sought authority under the rule for payment of any such claims, the rule was inapplicable and the claims under it groundless.

E.

To summarize on this second aspect of the case, we hold:

1. The *Fosdick* principle, essentially one of equitable

restitution on principles of mortgage law, and the special principle of receivership administration that emerged in *Miltenberger* are co-existing but distinct principles.

2. The *Fosdick* principle of equitable restitution provides for payment of claims for pre-reorganization current operating expenses from and to the extent of the existence of a current debt fund determined essentially as indicated in *New Haven* and in *In re Penn Central Transportation Co., supra,* 458 F. Supp. at 1322-23, except that depreciation is not deductible in determining the amount of the income component of the current debt fund.

3. The *Miltenberger* receivership-administration principle provides for payment of claims on the same basis and from the same operating income as administration expenses for pre-reorganization current operating expenses that satisfy the strict requirements of the class, that is, that they are claims for necessary current operating expenses not furnished in reliance on the railroad's general credit.

4. The Necessity of Payment rule, as it has emerged as a distinct third principle, does not confer rights on claimants; it rather reflects the existence of a judicial power to authorize trustees in reorganization to pay claims where such payment is exacted as the price of providing goods or services indispensably necessary to continuing the rail service, and it reflects the existence of a corollary judicial power to exculpate trustees who may have made such payments in exigent circumstances without first obtaining authorization by court order.

III

It follows from what has been said that the order of the district court of March 19, 1979, must be reversed in so far as it failed to provide a separate class of creditors, with priority pursuant to Section 77(b) of the former Bankruptcy Act, 11 U.S.C. § 205(b) (1976), now 11 U.S.C. § 1171(b), and in all other respects affirmed.

Reversed in part, affirmed in all other respects, and remanded for further proceedings consistent with this decision.

In the Matter of BOSTON AND MAINE CORPORATION, Debtor.

No. 70—250—M.

United States District Court,
D. Massachusetts.

March 12, 1979.

MEMORANDUM

FRANK J. MURRAY, Senior District Judge.

The Debtor's Trustees have petitioned the court to fix the division of creditors and stockholders in the reorganization proceedings according to the nature of their respective claims and interests, pursuant to Section 77(c)(7) of the Bankruptcy Act (the Act), 11 U.S.C. § 205(c)(7). The Trustees suggested an order of priorities of creditors and stockholders divided into eleven categories, to which objections were filed. The petition and objections came on to be heard by the court, after notice to the Interstate Commerce Commission (ICC) and to all creditors and stockholders, on the several stipulations of the Trustees and certain creditors, the briefs filed by the Trustees and certain objectors, and the oral arguments on behalf of the Trustees and certain creditors.

I. *Per diem claims*

Thirty-eight railroads[1] and Trailer Train Company (collectively the "interline claimants") object to the classification by the Trustees of their pre-organization per diem charges against the Debtor in a category subordinate to the holders of general unsecured claims. The interline claimants seek to have the court establish them as a separate class of creditors with respect to these per diem charges at a high-level priority, or at the very least at priorities under the "six months

[1] The railroads are: Baltimore And Ohio R. Co., Chesapeake And Ohio R. Co., Western Maryland Ry., Maine Central R. Co., Canadian Pacific R. Co., and the Committee of Interline Railroads which represents 34 railroads.

rule" or "necessity of payment rule". Earlier in the reorganization proceedings against the Debtor the question whether these per diem charges were entitled to priority over the claims of other creditors was raised when the interline claimants sought an order requiring the Trustees to make immediate payment of such charges. This court declined to follow the decision *In the Matter of Chicago, R.I. & P. R. Co.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied* 429 U.S. 1092, 97 S.Ct. 1102, 51 L.Ed.2d 537 (1977) (*Rock Island*) on the priority issue, and denied the interline claimants' petitions. *In the Matter of Boston and Maine Corporation, Debtor*, 456 F.Supp. 412 (D.Mass.1978). On the instant petition the interline claimants have again urged certain contentions which they raised in the earlier proceedings. Ordinarily, consideration of the same arguments would not be entertained. However, because the court is now called upon for the first time to undertake its statutory duty under section 77(c)(7) to fix the division of creditors and stockholders "for the purposes of the plan [of reorganization] and its acceptance", *id.*, it will not foreclose reconsideration of the arguments.

Interline claimants are not entitled to special priority

Pre-reorganization per diem charges are part of the operating expenses of the railroad, are unsecured debts within the meaning of the Bankruptcy Act [11 U.S.C. §§ 1(14), 205(b)], and are entitled to no designated preferred priority among the debts of the railroad in reorganization. Neither the Bankruptcy Act nor the Interstate Commerce Act, 49 U.S.C. § 1 *et seq.*, specifically provides for priority status of per diem claims over claims of other creditors.[2]

[2] This is particularly significant in light of the specific priority given certain claims in section 77. *See* 11 U.S.C. § 205(n) (claims of employees for personal injuries; claims of sureties on certain bonds); 11 U.S.C. § 205(c)(3) (claims under trustees' certificates); 11 U.S.C. § 205(b) (unsecured claims under the "six months rule"). *See In re Chicago Express, Inc.*, 222 F.Supp. 566, 571 (S.D.N.Y. 1963), *aff'd* 332 F.2d 276 (2d Cir. 1964), *cert. denied* 379 U.S. 879, 85 S.Ct. 146, 13 L.Ed.2d 86 (1964), where the court said: "Where Congress intended that special priorities be granted, 'it has carefully enumerated them, and any omissions must be construed as express exclusions . . .' ". (Citations omitted).

There is no explicit general order of the ICC directing the trustee of a railroad in reorganization to pay pre-reorganization per diem charges; there is no specific order of the ICC requiring the Trustees of this Debtor to pay such charges. There has been no demonstration that the interline carriers, some of them competitors of the Debtor, conferred on the Debtor such special benefits by the services for which the per diem charges were made as to equitably entitle them to a preference over all other creditors. The view of the Third Circuit with respect to pre-reorganization per diem charges interline claimants are entitled to no higher priority than other unpaid suppliers of goods and services delivered prior to the filing of the petition in reorganization. *In re Penn Central Transportation Company,* 486 F.2d 519, 528 (3rd Cir. 1973), *cert. denied* 415 U.S. 990, 94 S.Ct. 1588, 39 L.Ed.2d 886 (1974); *Matter of Penn Central Transportation Company,* 553 F.2d 12, 15 (3rd Cir. 1977), correctly appraises the interests of the interline claimants in relation to other creditors.

Relying on *Rock Island* the interline claimants contend, however, that because of the mandatory nature of certain ICC orders prescribing per diem rates and rules for the settlement of per diem accounts, the court must distinguish between the asserted singular nature of their per diem charges and claims of other creditors in any priority classification of creditors. As previously pointed out in this memorandum, this court declined to follow *Rock Island* on the priority issue, and there is nothing in the presentations made on the instant petition to persuade the court to change its views (1) that the rationale of *Rock Island* does not support a preferred priority status for per diem charges of approximately $8,018,000 for services performed before August 1, 1969, and (2) that to accord preferred priority to per diem charges of approximately $564,000 for pre-reorganization services rendered after August 1, 1969 would result, in the absence of clear and specific statutory authority and policy, in insulating interline carriers as creditors from the strictures of section 77 contrary to the intent of Congress.[3]

[3] It is undisputed that the Debtor's Trustees have paid all per diem charges at the ICC prescribed rates for car use furnished *after* the Trustees had assumed control over railroad operations.

Any consideration of the extensive powers of the reorganization court under section 77 to control and adjust the claims of creditors must take account of the traditional bankruptcy goals of that section: rehabilitation of the debtor and equitable distribution of the debtor's property to creditors. *See New Haven Inclusion Cases*, 399 U.S. 392, 420, 90 S.Ct. 2054, 26 L.Ed.2d 691 (1970). By the terms of section 77(c)(7), the traditional bankruptcy function of establishing priorities among creditors is exclusively that of the reorganization court, and not a function of the ICC.[4] Thus, the contention that the court's power to determine the priority of distribution of the property of a debtor in reorganization to a class of interline creditors in relation to the claims of other creditors has been circumscribed by the superseding authority of ICC, carries a very heavy burden of persuasion. That burden has not been met by the interline claimants; with respect, the court declines to follow the reasoning of the *Rock Island* court on the issue. Rather, the court concludes that proper consideration of the clear and specific applicable provisions of section 77, and its underlying policies, requires the ruling that the court is vested with the authority to determine the claims for special priority of pre-reorganization per diem

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Such action complies with their duty under section 77(c)(2) to operate the business of the Debtor "subject to the control of the judge and the jurisdiction of the Commission". However, the language of section 77(c)(2) cannot be read to displace the power of the court to determine the rights and liabilities of creditors, including interline creditors, for services rendered *before* the Trustees assumed control over railroad's operations. Neither can section 77(c)(2) be read to mandate retrospective application to pre-reorganization operations of the Trustees' "power to operate the business of the debtor". *Id.*

[4] Section 77(c)(7) must be considered with other provisions of section 77 particularly section 77(e) which provides that the reorganization court

> . . . shall approve the plan if satisfied that: (1) It . . . is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . .

charges and the classification of the interline claimants. Accordingly, for the reasons stated, the court determines that the interline claimants are not a special class of creditors entitled to special priority.

II. *Six Months Rule*

The interline claimants and certain other creditors[5] holding unsecured claims seek to have their claims approximating $3,000,000 accorded special priority under the so-called "six months rule". Debtor's Trustees contend that establishment of a separate class of creditors to be accorded priority as "six months creditors" is not justified under the circumstances of the case. In general, the parties are in agreement as to the origin of the rule and its elements; they do not entirely agree as to its intended application. They agree that it was made applicable to railroad reorganization proceedings by section 77(b), which provides in pertinent part:

> . . . unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

The rule was first enunciated in *Fosdick v. Schall*, 99 U.S. 235, 25 L.Ed. 339 (1879). Since that time the rule has been applied in numerous cases, resulting in many inconsistencies among the decisions of courts below the Supreme Court. *Compare, e.g., In the Matter of Penn Central Transp. Co.*, 458 F.Supp. 1234 (E.D.Pa.1978) ("*Penn Central*") and *In the Matter of New York, New Haven and Hartford R. Co.*, 278 F.Supp. 592 (D.Conn.1967) ("*New Haven*") *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999, 89 S.Ct. 1592, 22 L.Ed.2d 776 (1969) with *Southern Ry. v. Flournoy*, 301 F.2d 847 (4th Cir. 1962). Because its application depends upon the facts peculiar to each case, *Southern Ry. Co. v. Carnegie Steel Co.*, 176 U.S. 257, 20 S.Ct. 347, 44 L.Ed. 458 (1900), the

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[5] The other creditors are Eastern Associated Coal Corporation, Exxon Corporation, Uniroyal Inc., and Francis J. Robertson.

rationale of the rule is most important. In *Fosdick* the Court said:

> [W]hen companies become pecuniarily embarrassed, it frequently happens that debts for labor, supplies, equipment and improvements are permitted to accumulate, in order that bonded interest may be paid and a disastrous foreclosure postponed, if not altogether avoided. In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees.

99 U.S. 252-53.

To qualify under the rule a creditor must establish (1) that the claim represents a current operating expense of the railroad necessarily incurred, (2) that it was incurred within six months prior to the filing of the reorganization petition, and (3) that the goods or services were delivered on credit with the expectation that the debt would be paid out of the current operating revenues of the railroad, and not in reliance on the railroad's general credit. *Penn Central, supra* at 1321. However, it must also be proved, before any right to priority under the rule can be established, that a "current

debt fund" (also sometimes referred to as a "current expense fund") exists, or should equitably be re-created, out of which priority payments can be made. *Id.* The question whether such fund exists or should be re-created is the principal point of dispute between the Trustees and the creditors, and is the sole issue to be determined with reference to the six months rule on this petition.

Before addressing the issue of the "current debt fund", certain general principles concerning the applicability of the rule should be noted. The rights of qualified six months creditors are superior to the rights of the mortgagees in the current operating revenues of the railroad. *Fosdick v. Schall, supra* 99 U.S. at 252-53. Six months creditors have no rights in the "corpus" of the debtor's estate except to the extent that current revenues have been improperly diverted for the benefit of the mortgagees. *Id.* at 254; *New Haven, supra* at 602; *Penn Central, supra* at 1321. The priority of qualified six months creditors is superior to the claims of pre-bankruptcy secured creditors, *New Haven, supra* at 597-98, but not to the claims of administration expenses incurred during the reorganization period. *Penn Central, supra* at 1321. The trustee of a railroad in reorganization is responsible only for funds coming into his hands, and he cannot be required to recover payments made by the railroad before bankruptcy of non-operating current debts. *See Penn Central, supra* at 1321.

Current Debt Fund

The existence of the current debt fund is to be determined as of the date of distribution of the debtor's estate, with the relevant period beginning six months before the reorganization petition was filed and including the reorganization period. *Penn Central, supra* at 1323; *accord, New Haven, supra* at 600. Hence, a classification determination made prior to distribution may be subject to later revision if circumstances change.

The six months rule does not operate to impress an equitable lien upon operating revenues, or upon net income, received during the six months period, or at some later point

of time before the date of distribution, as earmarking the current debt fund. The rule stems from the familiar rule of courts of equity when administering a fund or property in the hands of its officer—receiver or trustee—and applies when making disposition of the earnings of property in the custody of the court. *See Fosdick, supra; see also In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir. 1964). The Trustees argue that *New Haven* should be followed, with certain modifications, as to possible sources of the current debt fund. In *New Haven* Judge Anderson pointed out that

> [s]uch a fund may arise out of one or more of the following: (a) current earnings in the sense of surplus earnings during the six months period and during the reorganization itself; (b) unmortgaged assets of the debtor; and (c) income diverted during the six months period or during the reorganization for the benefit of the mortgagees.

278 F.Supp. at 598. The same formulation was adopted by Judge Fullam in *Penn Central*, with some doubt expressed by him as to the propriety of inclusion of unmortgaged assets. The interline claimants contend that this formulation is not in accord with *Fosdick* and other Supreme Court cases and, therefore, should not be followed.

1. *The revenue element*

The objecting creditors argue that contrary to *New Haven* and *Penn Central* the source of the revenue element of the current debt fund is the railroad's "current receipts". In their memorandum of law the interline claimants say, at page 19: "The current debt fund, as identified and defined in *Fosdick* . . . and other Supreme Court cases, is a very simple concept: The fund is a company's current receipts". However, they do not identify in the evidence what they refer to as the "current receipts" of the Debtor here. They avoid explicitly identifying "current receipts" with the Debtor's "gross operating revenues". What they have done is to direct the court's attention to the gross operating revenues of the Debtor of $34,047,000 for the six months prior to March 12, 1970, and $713,535,000 through July 13, 1978, and argue from these amounts that "[t]here were, thus, ample current

receipts available during the six months period in a 'current debt fund' to pay six months operating creditors". Memorandum ... of Interline Railroads, p. 22.

This oversimplification does not purport to demonstrate that any of the receipts realized during the six months period were "kept from those to whom in equity they belong, and used to pay the mortgage debt". *Fosdick, supra* 99 U.S. at 253. The argument focuses merely on the phrase "current receipts" and ignores the rationale of the rule. It fails to consider whether any funds came into the hands of the Trustees when they were appointed, and fails to take into account what uses were made of the gross operating revenues during the six months period. The determination whether a current debt fund exists or should be re-created involves an inquiry into the debtor's operations much beyond the mere observation that indeed there were current receipts because there were gross operating revenues. The court rejects, as either unclear or a misconstruction of the phrase "current receipts," the argument of the interline claimants that the current debt fund is merely the "current receipts". Rather, the court will adopt, with perhaps some reservation at this juncture, the definition in *New Haven* as follows:

> The current expense fund available from earnings can be defined ... as the sum of all operating revenues which have accrued during the six months period and in the course of reorganization, and which have actually been received or taken over by the Trustees, less depreciation and all operating expenses which have actually been paid or are payable by the Trustees or which constitute administration expenses.

278 F.Supp. at 599.

In affirming *New Haven,* the Second Circuit Court of Appeals stated:

> We hold that the availability of a current expense fund under the six months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission, and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.

In re N.Y., N.H. & Hartford R.R. Co., 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999, 89 S.Ct. 1592, 22 L.Ed.2d 776 (1969).

The evidence here clearly demonstrates that there is no basis for finding the existence of a current expense fund from the operating revenues. No surplus revenues accrued in the six months period and during the course of reorganization.[6] The current liabilities of the railroad of $30,929,401 exceeded the current assets of $14,704,246 by approximately $16,000,000 when the Trustees assumed control on March 12, 1970. The railroad incurred a net loss from railway operations during the six months period of $3,588,000, and if non-operating net income realized during this period were added, there still was a net loss of $3,441,000. There has been no showing that there is presently a surplus of operating income in the hands of the Trustees. During the entire period from six months prior to the filing of the petition on March 12, 1970 until July 31, 1978 there was a net loss from railway operations of $40,720,000, and a deficit in income available for fixed charges of about $29,407,000. Whether any of the operating revenues were "kept from those to whom in equity they belong" remains to be considered.

2. *Diversion for benefit of mortgagees*

Where the Trustees do not possess surplus earnings in their hands to satisfy six months creditors' claims, the court may look to the corpus of the estate for any income diverted during the relevant period for the benefit of the mortgagees. *See Fosdick, supra* 99 U.S. at 254. Supreme Court cases and other federal cases hold that an invasion of the corpus of the estate for this purpose is permissible only to the extent that the current debt fund has been diverted to the benefit of mortgagees. *See, e.g., Fosdick, supra* 99 U.S. at 254:

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[6] During the period September 13, 1969 through December 31, 1977, gross operating revenues of the Debtor totalled $696,552,000, and gross operating expenses, including a depreciation allowance of $33,212,000, totalled $739,055,000. These figures, and the figures used in the analysis of the evidence which follows are taken from the Debtor's schedules filed with the ICC.

> [I]f it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies and the like, it is within the power of the court to use the income . . . to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. . . .
>
> * * * * * *
>
> Whatever is done [by the court] must be with a view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of diversion. (underscoring added)

See also St. Louis, A. & T. H. R.R. Co. v. Cleveland, C., C. & I. R. Co., 125 U.S. 658, 674, 8 S.Ct. 1011, 31 L.Ed.2d 832 (1888); *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 187, 25 S.Ct. 415, 49 L.Ed. 717 (1905); *New Haven, supra* 278 F.Supp. at 602; *Penn Central, supra* at 82.

There is some opinion to the contrary, *see, e.g., Southern Railway Co. v. Flournoy*, 301 F.2d 847 (4th Cir. 1962); *In re Tennessee Central Ry. Co.*, 316 F.Supp. 1103, 1111-12 (M.D.Tenn.1970). However, the better view and the weight of authority clearly require the showing of a diversion of income for the benefit of the mortgagees before invasion of the corpus for the benefit of six months' creditors will be permitted. In *Johnson Fare Box Company v. Doyle*, 250 F.2d 656, 657 (2d Cir. 1958), *cert. denied* 357 U.S. 938, 78 S.Ct. 1385, 2 L.Ed.2d 1551 (1958), the court emphasized that:

> The so-called six months' priority rule is an invasion of the established contract rights of lienholders. As an invasion the rule should be strictly contained within narrow confines and limited to the purposes which brought it into being.

Plainly the rationale of the rule requires, contrary to the view expressed in *Flournoy*, that income diversion to the mortgagees be "the sine qua non of corpus invasion". 301 F.2d at 851.

The cases have held that payments out of income, that should have gone into the current debt fund, made for the benefit of the mortgagees such as payments for principal and interest, *Fosdick, supra,* 99 U.S. at 253, increments in the mortgage security, *New Haven, supra* 278 F.Supp. at 603, capital improvements to mortgaged property, *Fosdick, supra* 99 U.S. at 253, *Southern Ry. Co. v. Carnegie Steel Co.,* 176 U.S. 295, 20 S.Ct. 347, 44 L.Ed. 458 (1900), new acquisitions of property which became subject to the mortgage, *Gregg v. Metropolitan Trust Co.,* 124 F. 721, 722 (6th Cir. 1903), *aff'd* 197 U.S. 183, 25 S.Ct. 415, 49 L.Ed. 717 (1905), and, under certain circumstances, payments of equipment trust obligations, *see Southern Railway Co. v. Carnegie Steel Co., supra and New Haven, supra* 278 F.Supp. at 603, constitute diversions.

The objecting creditors contend that substantial diversions occurred before and after March 12, 1970, and, accordingly, that the six months creditors are entitled to preferential payment at least to the extent of the alleged diversions. The interline claimants argue that these diversions may be shown in the table set out in the footnote.[7] But it is not enough merely to show expenditures for obligations or acquisitions of property that indeed have the appearance of diversions; it must also be proved that the expenditures were made out of funds "kept from those to whom in equity they belong, and used to pay the mortgage debt". *Fosdick, supra 99 U.S. at 253.*

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[7] The interline claimants contend the items appearing below are shown in Schedule 1 to Exhibit A to the Trustees' answers to interrogatories. It should be noted however, that the amount of item 15 in Schedule 1 is $2,600,000, and not $2,590,000 as appears below. It should also be noted that the actual total of the items is $16,332,000, not $14,960,000, as shown below.

Items	
12. Payment to mortgagees:	
Pre-petition (principal and interest)	$ 92,000.
14. Conditional sales contract payments:	
Pre-petition (principal and interest)	675,000.
15. Equipment trust payments:	
Principal and interest	2,590,000.
17. Capital expenditures (less amount financed):	
Equipment and tangible personal property	10,862,000.
Improvements	2,013,000.
Total	$14,960,000.

The Trustees present a two-pronged argument that no diversions for the benefit of secured creditors occurred.[8]

a.

In the first phase of their argument they stress, in effect, that contributions were made to the income fund from sources other than income from operations, and that such contributions must be considered as a reimbursement pro tanto on account of payments of pre-reorganization secured obligations and for improvements to pre-reorganization mortgaged property. They also argue that payment of Equipment Trust # 1, a pre-reorganization secured obligation, resulted in the acquisition of property unencumbered by pre-reorganization mortgage security interest. The Trustees'

With reference to item 17, the evidence does not show whether the equipment and tangible personal property were additions, betterments or improvements to mortgaged property. Because "ambiguities must generally be resolved against those claiming benefit of the rule", *In the Matter of New York, New Haven and Hartford R. Co.*, 278 F.Supp. 592, 596 (D.Conn.1967) ("New Haven"), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999, 89 S.Ct. 1592, 22 L.Ed.2d 776 (1969), there can be no presumption that the equipment and tangible personal property effected increments to the mortgage security.

[8] "The total of all payments of pre-reorganization secured obligations and for improvements to property subject to pre-organization mortgages exclusive of such payments made with the proceeds of sale of mortgaged assets and payments which resulted in the acquisition of property unencumbered by pre-reorganization mortgages and security interest—that sum is less than the sum of proceeds of sales of mortgage property and of scrap of mortgage property used to pay operating expenses.

"All of this is wholly without reference to the impact of depreciation. The Trustees ... submit that so long as the sum of all payments of pre-reorganization secured obligations and additions, betterments and improvements to mortgaged property is less than depreciation, there can be no inequitable diversion in favor of secured creditors which requires the re-creation of a fund for payment of a six month priority."

"Trustees' Brief ... Order No. 398" at 22-23.

computation submitted in response to the court's order of February 5 shows that total payments of $7,648,000 of pre-reorganization secured obligations and for improvements to mortgaged property were paid in part from the proceeds of the sale of mortgaged property in the sum of $2,244,000. The Trustees argue that the remainder of $5,404,000 is more than offset by contributions to operating income from the proceeds of the sales of mortgaged property of $3,079,000, and of scrap of mortgaged property of $2,583,000.

The $2,583,000 were contributed to operating income generally for operating expenses. The $3,079,000 proceeds were paid to settle property taxes outstanding on March 12, 1970.[9] Thus these contributions totalling $5,662,000 may be considered as reimbursement pro tanto to replace revenues used for the payments of secured obligations. *See Central Trust Co. of New York v. East Tennessee V. & G. R.R. Co.*, 80 F. 624, 625-26 (6th Cir. 1897). These payments from the proceeds of the sales of mortgaged property were made out of what were referred to in *New Haven, supra* at 603, as "free funds", and not out of earnings.

The Trustees' argument that payment of Equipment Trust # 1 of $2,600,000 should be an additional offset against the total payment of $7,648,000 because the property acquired is unencumbered, is not persuasive. The parties have not agreed that the acquisition is unencumbered property, and because its status as such is, at best, in doubt, the court has not considered the value of the acquisition an offset to pre-reorganization obligation payments. However, with the $2,600,000 item excluded as an offset it has been demonstrated nevertheless that no diversion for the benefit of the mortgagees occurred as a result of the payments referred to.

b.

The second prong of the Trustees' argument is that no diversions occurred because the depreciation allowance in the income account under the ICC reporting system exceeds the aggregate of all payments made on pre-reorganization secured obligations and for increments to mortgaged prop-

[9] Property taxes are railway operating expenses. Exhibit A.

erty. The depreciation allowance in the income account (Schedule 1 of Exhibit A, item 11) is $33,212,000, an amount in excess of the sum of $5,635,000 (payments out of operating income made on pre-reorganization secured obligations) and $12,875,000 (capital expenditures for equipment and tangible personal property and improvements, Schedule 1 of Exhibit A, item 17).[10] It is the contention of the interline claimants that "depreciation is irrelevant to the rule", and that in any event because depreciation is an accounting concept "there is no reason to believe that it necessarily reflects the amount of any real deterioration in the value of the equipment involved". Interline Claimants' Brief at 27. In *New Haven* the court pointed out that

> [depreciation] is a reflection of the very real economic fact that the assets are being consumed or wasted away in the process of keeping the railroad running and is actually a measure of the contribution of physical properties made by the mortgagees for this purpose. . . . Allowance of depreciation is comparable to expenditures made merely to preserve and not to increase the mortgaged assets and as such are not diversions.

278 F.Supp. at 604. The court in *Penn Central* adopted the view expressed in *New Haven*. It must be recognized as a matter of common knowledge that the ordinary wear and tear of railroad assets by operations can be foreseen, and such assets will become exhausted unless measures are taken to keep them in repair or replace them. Physical deterioration of railroad property and equipment caused by operations is inevitable; functional depreciation, perhaps, cannot be foreseen with the same degree of accuracy as physical deterioration but it is an economic fact nevertheless. To offset depreciation it is necessary to take care of the property to maintain its efficiency, or to replace property when it is no

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[10] In footnote 7, *supra*, the court concluded that on the evidence now before the court the equipment and tangible personal property listed in item 17 of Schedule 1 of Exhibit A was not shown to be increments to the mortgage security. Solely for the purpose of analyzing the Trustees' argument on depreciation the court has treated such property as arguably a benefit to secured creditors, without deciding that it is.

longer efficient, or to set up new assets or reserves to take the place of the losses caused by wear and tear or functional decline. The use of revenues to offset depreciation serves the purposes of Section 77 which are, *inter alia,* to conserve the debtor's assets for the benefit of all creditors and to preserve an ongoing railroad in the interest of the public.

The court rejects the contentions of the interline claimants, and adopts the view of the *New Haven* and *Penn Central* courts that depreciation does not result in enhancement of the mortgaged assets and is not to be regarded as a diversion.

Analysis of this phase of the Trustees' argument is necessary to determine the effect of the allowance for depreciation on the operating income during the relevant period under the six months rule. It is apparent that certain adjustments should be made to the net railway operating deficit of $42,503,000. Reduction of this deficit by disallowing the capital expenditures for equipment and tangible personal property and improvements, totalling $12,875,000, and the payments of pre-reorganization secured obligations of $5,635,000, will eliminate any expenditures which arguably might have benefited the mortgagees. There should also be disallowed the $3,000,000 of claims of the six months creditors. These reductions result in an adjusted net railway operating deficit of $20,993,000. If these same items are disallowed in the deficit status of income available for fixed charges of $33,216,000 the result is an adjusted deficit of $14,706,000 in that account. Thus, disallowance of the factors which arguably may aid the claims of the six months creditors still leaves a deficit of operating income and income available for fixed charges, demonstrating that there are no earnings available to re-create a current debt fund.

3. *Unmortgaged assets*

The Trustees claim that they hold certain property unencumbered by the lien of any mortgage. Included in that property are items of cash, accounts receivable, wharf property in Portsmouth, New Hampshire, securities and other assets of leased lines and of subsidiary companies, and investment

securities. The Trustees also claim as unencumbered property that which was formerly subject to Equipment Trust # 1 and their equity in certain equipment and tangible personal property acquired during the reorganization proceedings. These claims are made by the Trustees with realization that the mortgagees may assert some of this property is subject to mortgage liens.

The court has herein declined to view the value of the Equipment Trust # 1 property as an offset to pre-reorganization obligation payments, and, accordingly, will not view it as unmortgaged assets at this stage of the Trustees' argument. Similarly the court pointed out that the creditors have not demonstrated that the equipment and tangible personal property in item 17 of Schedule 1 to Exhibit A, see footnote 7 above, were increments to the mortgage security. The court will not review those rulings here. The "unmortgaged assets" aspect of the case will be considered without reference to either the Equipment Trust # 1 property or the equipment and tangible personal property.

The six months claimants have not argued that "unmortgaged assets" should be deemed a source of current debt fund. Although "unmortgaged assets" were discussed in *New Haven* and *Penn Central* as a source of a current debt fund, in neither case did "unmortgaged assets" become an issue. In their respective discussions, those courts were not in agreement as to whether such assets should be included as a source.[11]

Recourse to unmortgaged assets as a source of a current debt fund undermines the rationale of the six months rule,

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[11] In *New Haven,* use of unmortgaged assets as a source of a current debt fund was based on an earlier Second Circuit decision, *Pennsylvania Steel Co. v. New York City Ry.*, 216 F.458 (2d Cir. 1914), where, as a matter of public policy, the six months creditors were preferred over other creditors, on the strength of the unmortgaged assets of the railroad, because they (the six months creditors) had supported a financially troubled railroad. Judge Fullam, in *Penn Central,* expressed "great difficulty squaring this reasoning with the fundamental basis for a six months priority, namely, reliance of current operations creditors upon current revenues". 458 F.Supp. 1321, n.81.

which is that six months creditors in providing goods and services to the railroad, relied for payment upon the income generated by their contributions to the current operations of the railroad, and not upon the railroad's general credit. *See Fosdick, supra* 99 U.S. at 252-53. In light of the fact that the six months creditors have not asserted a claim against unmortgaged assets as a source of a current debt fund, and because inclusion of unmortgaged assets in such a fund would not represent restoration of funds "kept from those to whom in equity they belong, and used to pay the mortgage debt", *id.,* 99 U.S. at 253, the court will not look to unmortgaged assets of the Debtor, if any, as a source of a current debt fund.

For the foregoing reasons, the court concludes that no current debt fund exists or should in equity be re-created and, therefore, that no separate priority classification for six months creditors should be designated.

III. *Necessity of Payment Rule*

The interline claimants and certain other creditors assert a claim for priority founded upon the so-called "necessity of payment rule". The claims are for per diem charges, private car rentals, car repairs, damaged and destroyed cars, and diesel fuel. The parties have stipulated that no creditor claiming under this rule has insisted on payment of its claim as a condition of its providing goods and services to the Debtor, and that the Trustees have never sought authority from the court under this rule for payment of any such claims.

In *Miltenberger v. Logansport Railway Company,* 106 U.S. 286, 1 S.Ct. 140, 27 L.Ed. 117 (1882), where the rule was first enunciated, the Court held that where payment of a pre-reorganization claim was necessary for the continued operation of the railroad during reorganization, the court may permit the trustee to pay the claim though it was not entitled to special priority. Justice Holmes pointed out in *Gregg v. Metropolitan Trust Co.,* 197 U.S. 183, 187, 25 S.Ct. 415, 416, 49 L.Ed. 717 (1905), that the "ground of such allowance as was made [in *Miltenberger*] was not merely that the supplies were necessary for the preservation of the road, but that the

payment was necessary for the business of the road,—a very different proposition".

The necessity of payment rule is not a rule of priority; it is a rule of payment. "The necessity of payment rule is not based on considerations of equity but is rather a device for handling a threat to the continued operation of the railroad during reorganization. If there is no such threat, the rule is not applicable." *New Haven, supra* at 603, n.15 (underscoring added). Here the evidence and the stipulation demonstrate that the rule is inapplicable, and the claims under the rule must be denied.

IV. *Objections of the United States*

The United States has asserted non-tax pre-reorganization claims against the Debtor which include Federal Railroad Administration safety claims, United States Department of Agriculture overcharge claims, United States Department of Agriculture loss and damage claims, and Government Accounting Office overcharge and loss and damage claims. Its objection to the Trustees' proposed classification seeks establishment by the court of a separate class for these claims between proposed categories 4 and 5, based upon the provisions of 31 U.S.C. § 191.[12] Although the Trustees in their brief disputed the asserted priority, at the hearing on the petition counsel for the Trustees withdrew the objection to the claims of the United States and agreed to the asserted priority provided that the United States prove the conditions

[12] 31 U.S.C. § 191 provides:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

specified in 31 U.S.C. § 191 for the establishment of the priority. In this regard, both parties agreed to submit to the Interstate Commerce Commission for its determination the question whether the estate of the Debtor is insolvent in the bankruptcy sense. The court has not been informed of any further action in connection with this matter.

V. *Objections of the Town of Madbury, New Hampshire*

The Town of Madbury, New Hampshire objects to the Trustees' proposed classification by claiming that its tax lien on the proceeds of the sale of certain real property is entitled to a priority over all other claims. Class 2 as proposed by the Trustees provides for the proper priority of this tax claim, and no showing has been made of any cogent reason why a separate classification should be created for the tax lien of Madbury, New Hampshire.

VI. *Conclusion*

The court concludes that the fair division of creditors and stockholders on the showing made in these proceedings should have as of the date of entry of this order the following priority under Section 77(c)(7) of the Bankruptcy Act:

1. Administration claims.
2. State and local tax claims against the Debtor which became a lien upon the property of the Debtor prior to March 12, 1970, excepting state and local tax claims to the extent waived by agreement between the Trustees and the taxing authorities.
3. The holders of First Mortgage Bonds.
4. The holders of Income Bonds.
5. Claims of the United States of America under 31 U.S.C. § 191.
6. The holders of claims, other than claims secured by valid liens, of federal, state and local governmental authorities for taxes found by the court to be based on fair and valid assessments and either secured or to have become legally due and owing during the three-year period preceding March 12,

1970, or otherwise to be entitled to priority in accordance with the provisions of the Bankruptcy Act, excepting state and local tax claims to the extent waived by agreement with the taxing authorities.

7. The holder of 7½% collateral promissory note, dated June 25, 1969, in the original principal amount of $694,042.34 issued to the National Shawmut Bank of Boston, payable serially to June 15, 1970.

8. The holders of secured claims of the Debtor duly proved in this proceeding and allowed by the court, which security interests are subordinate to the mortgages of the First Mortgage Bonds and the Income Bonds.

9. The holders of general unsecured claims against the Debtor duly proved in this proceeding and allowed by the court (whether or not incurred within six months preceding March 12, 1970, and whether or not arising from the provision of goods and services necessary to the Debtor's operations) including without limitation the promissory note of the Debtor given to Southern Railway Association, and all claims arising by reason of the disaffirmance or rejection, or the failure of the Trustees to accept, any executory contract or unexpired lease of the Debtor to the extent of the actual damage or injury sustained, determined in accordance with the principles of the Bankruptcy Act. In addition, all claims of other railroads' per diem charges in excess of those paid by the Debtor during the period August 1, 1953 through March 12, 1970.

10. Five percent Preferred Stockholders.

11. Common Stockholders.

It is so ORDERED.

Appendix B.

Repealed 11 U.S.C. § 205(c)(2)
[in pertinent part]

(c) After approving the petition:

. . .

(2) . . . The trustee or trustees so appointed, upon filing such bond, shall have all the title and shall exercise, subject to the control of the judge and consistently with the provisions of this section, all of the powers of a trustee appointed pursuant to section 72 or any other section of this title, and, to the extent not inconsistent with this section, if authorized by the judge, the powers of a receiver in an equity proceeding, and, subject to the control of the judge and the jurisdiction of the Commission as provided by the Interstate Commerce Act as now or hereafter amended, the power to operate the business of the debtor. In operating the business of the debtor with respect to safety, location of tracks, and terminal facilities, the trustee or trustees shall be subject to lawful orders of State regulatory bodies of statewide jurisdiction to the same extent as would the debtor if a petition respecting it had not been filed under subdivision (a) of this section except that (A) any such order which would require the expenditure, or the incurring of an obligation for the expenditure, or the incurring of an obligation for the expenditure, of money from the debtor's estate shall not become effective (a) unless the trustee or trustees, with the approval of the court, shall consent thereto, or (b) unless the Commission, upon appropriate application or applications by an interested party or interested parties, shall find that compliance with the order will not impair the ability of the trustees or trustees to perform his or their duties to the public, will not constitute an undue burden upon interstate commerce, will be compatible with the public interest, and will not interfere with the formulation and approval of a satisfactory plan of reorganization for the debtor, and (B) compliance shall be made with any applicable provision of the Interstate Commerce Act. . . .

Repealed 11 U.S.C. § 205(c)(7)

(c) After approving the petition:

. . .

(7) The judge shall promptly determine and fix a reasonable time within which the claims of creditors may be filed or evidenced and after which no claim not so filed or evidenced may participate except on order for cause shown, the manner in which such claims may be filed or evidenced and allowed, and for the purposes of the plan and its acceptance, after notice and hearing, the division of creditors and stockholders into classes according to the nature of their respective claims and interests. Such division shall not provide for separate classification unless there be substantial differences in priorities, claims, or interests. The trustee or trustees under any mortgage, deed of trust, or indenture outstanding against the property may, within the time prescribed, file a verified claim in behalf of all bonds or securities outstanding under such mortgage, deed of trust, or indenture, in which event it shall be unnecessary for the holders of such bonds or securities to file claims in their own behalf, but nothing herein shall constitute such trustee or trustees the representative or representatives of such holders for the purpose of accepting or rejecting any plan of reorganization.

49 U.S.C. § 1
The Interstate Commerce Act

§ 1, par. (4). [DUTY TO FURNISH TRANSPORTATION AND ESTABLISH THROUGH ROUTES; DIVISIONS OF JOINT RATES.] It shall be the duty of every common carrier subject to this chapter to provide and furnish transportation upon reasonable request therefor, and to establish reasonable through routes with other such carriers, and just and reasonable rates, fares, charges, and classifications applicable thereto; and it shall be the duty of common carriers by railroad subject to this chapter to establish reasonable through routes with common carriers by water subject to chapter 12 of this title, and just and reasonable rates, fares,

charges, and classifications applicable thereto. It shall be the duty of every such common carrier establishing through routes to provide reasonable facilities for operating such routes and to make reasonable rules and regulations with respect to their operation, and providing for reasonable compensation to those entitled thereto; and in case of joint rates, fares, or charges, to establish just, reasonable, and equitable divisions thereof, which shall not unduly prefer to prejudice any of such participating carriers.

. . .

§ 1, par. (5). [JUST AND REASONABLE CHARGES.] All charges made for any service rendered or to be rendered in the transportation of passengers or property as aforesaid, or in connection therewith, shall be just and reasonable, and every unjust and unreasonable charge for such service or any part thereof is prohibited and declared to be unlawful.

. . .

§ 1, par. (10). ["CAR SERVICE" DEFINED.] The term "car service" in this chapter shall include the use, control, supply, movement, distribution, exchange, interchange, and return of locomotives, cars, and other vehicles used in the transportation of property, including special types of equipment, and the supply of trains, by any carrier by railroad subject to this chapter.

. . .

§ 1, par. (11). [DUTY TO FURNISH CAR SERVICE; RULES AND REGULATIONS.] It shall be the duty of every carrier by railroad subject to this chapter to furnish safe and adequate car service and to establish, observe, and enforce just and reasonable rules, regulations, and practices with respect to car service; and every unjust and unreasonable rule, regulation, and practice with respect to car service is prohibited and declared to be unlawful.

. . .

§ 1, par. (14). [PRIOR TO 1966 AMENDMENT.] [ESTABLISHMENT BY COMMISSION OF RULES, ETC., AS TO CAR SERVICE.]

(a) The Commission may, after hearing, on a complaint or upon its own initiative without complaint, establish reasonable rules, regulations, and practices

with respect to car service by common carriers by railroad subject to this chapter, including the compensation to be paid and other terms of any contract, agreement, or arrangement for the use of any locomotive, car, or other vehicle not owned by the carrier using it (and whether or not owned by another carrier), and the penalties or other sanctions for nonobservance of such rules, regulations, or practices.

§ 1, par. (14). [INCLUDING 1966 AMENDMENT AND 1976 AMENDMENT.] [ESTABLISHMENT BY COMMISSION OF RULES, ETC., AS TO CAR SERVICE; PROCEDURES APPLICABLE.]

(a) It is the intent of the Congress to encourage the purchase, acquisition, and efficient utilization of freight cars. In order to carry out such intent, the Commission may, upon complaint of an interested party or upon its own initiative without complaint, and after notice and an opportunity for a hearing, establish reasonable rules, regulations, and practices with respect to car service by common carriers by railroad subject to this chapter, including (i) the compensation to be paid for the use of any locomotive, freight car, or other vehicle, (ii) the other terms of any contract, agreement, or arrangement for the use of any locomotive or other vehicle not owned by the carrier by which it is used (and whether or not owned by another carrier, shipper, or third party), and (iii) the penalties or other sanctions for nonobservance of such rules, regulations, or practices. In determining the rates of compensation to be paid for each type of freight car, the Commission shall give consideration to the transportation use of each type of freight car, to the national level of ownership of each such type of freight car, and to other factors affecting the adequacy of the national freight car supply. Such compensation shall be fixed on the basis of the elements of ownership expense involved in owning and maintaining each such type of freight car, including a fair return on the cost of such type of freight car (giving due consideration to current costs of capital, repairs, materials, parts and labor). Such compensation may be increased by any incentive element which will, in

the judgment of the Commission, provide just and reasonable compensation to freight car owners, contribute to sound car service practices (including efficient utilization and distribution of cars), and encourage the acquisition and maintenance of a car supply adequate to meet the needs of commerce and the national defense. The Commission shall not make any incentive element applicable to any type of freight car if the Commission finds that the supply of such type of freight car is adequate. The Commission may exempt such incentive element from the compensation to be paid by any carrier or group of carriers if the Commission finds that such an exemption is in the national interest.

. . .

§ 1, par. (17). [DIRECTIONS OF COMMISSION AS TO CAR SERVICE; DISOBEDIENCE; RIGHTS OF STATES; BRIBERY.] . . . It shall be the duty of all carriers by railroad subject to this chapter, and of their officers, agents, and employees, to obey strictly and conform promptly to such orders or directions of the Commission, and in case of failure or refusal on the part of any carrier, receiver, or operating trustee to comply with any such order or direction such carrier, receiver, or trustee shall be liable to a penalty of not less than $100 nor more than $500 for each such offense and $50 for each and every day of the continuance of such offense, which shall accrue to the United States and may be recovered in a civil action brought by the United States . . . .

No. 80-1196

In the Supreme Court of the United States

OCTOBER TERM, 1980

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
PETITIONERS,

v.

ROBERT W. MESERVE AND BENJAMIN H. LACY, REORGANIZATION TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR, and THE FIRST NATIONAL BANK OF BOSTON AND MALCOLM W. HALL, SUCCESSOR INDENTURE TRUSTEES, ET AL.,
RESPONDENTS.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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I

Questions Presented

1. Are the Petitioners barred or estopped from seeking a writ of certiorari with respect to the questions presented in their Petition as a consequence of *In re Boston and Maine Corp.*, 456 F. Supp. 412 (D. Mass. 1978), *aff'd*, 600 F.2d 307 (1st Cir. 1979)?

2. Does the refusal of a railroad reorganization court to accord to pre-reorganization unsecured per diem claims a special full-payment priority not specifically provided for under the Bankruptcy Act or Interstate Commerce Act effect retroactively an unconstitutional taking of claimants' cars without just compensation when (1) the bulk of the claims are for compensation at rates determined by or pursuant to private agreement, (2) there has been no showing that the compensation received in connection with the loan of their cars was unjust in the context of their entire business or that the regulations to which claimants were subject caused a loss in their overall business, (3) there is no showing that any failure of just compensation was a necessary consequence of or compelled by government action or regulation and (4) over a seventeen year period claimants failed to raise the question or take any action to protect themselves against a credit loss?

3. May the court in railroad reorganization proceedings properly refuse to accord to pre-petition unsecured per diem claims a special full-payment priority not specifically provided for under the Bankruptcy Act or the Interstate Commerce Act on the basis of alleged national transportation needs and Commission orders when (1) Congress, in connection with the Bankruptcy Reform Act of 1978, has explicitly rejected such a priority on the ground that it would violate the principle of equality of treatment of creditors, (2) the bulk of such claims are private claims in contract or *quantum meruit*, (3) such claims are admittedly not obligations of the reorganization trustees, and (4) where the national transportation needs which allegedly call for such priority may not be served by such priority or be presently relevant?

II

Parties

Respondents submitting this Brief in Opposition are the Reorganization Trustees of the estate of the Boston and Maine Corporation, Debtor, and the First National Bank of Boston and Malcolm W. Hall, successor indenture trustees under the indenture pursuant to which the Debtor's first mortgage bonds are outstanding. Additional Respondents are the Maine Central Railroad Company, Portland Terminal Company, and Eastern Associated Coal Corporation. Petitioners herein are the Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company, and Western Maryland Railway.

For purposes of Supreme Court Rule 28.1, it is hereby disclosed that: (a) the Reorganization Trustees of the Boston and Maine Corp., Debtor, as such, own stock in or are otherwise affiliated with the following companies: Springfield Terminal Railway Co., Stony Brook Railroad, Northern Railroad, Vermont and Massachusetts Railroad, Mystic Terminal Co., Pullman Co., Pine Tree Corp., Connecticut River Valley Co., Inc., Trailer Train Co., North Station Industrial Building, Inc., and North Station Hotel Building, Inc.; (b) The First National Bank of Boston ("The Bank") is, except for directors' qualifying shares, a wholly-owned subsidiary of First National Boston Corporation ("The Parent").

The Bank has no direct or indirect material beneficial interest in this litigation but is acting solely in its fiduciary capacity as corporate trustee of the First Mortgage Indenture of Boston and Maine Corporation, and is uncertain whether under this circumstance Rule 28.1 contemplates that its individual corporate affiliations be listed. Such affiliations do not attach to the trustees as such under said mortgage. Those affiliations are as follows:

The Bank

The Bank is a national banking association with its principal office in Boston, Massachusetts. Except for directors' qualifying shares, all of its outstanding stock is held beneficially and of record by the Parent. The Bank has a number of wholly-owned subsidiaries one or more of which, in turn, has one or more wholly-owned subsidiaries. Except as hereinafter stated, all of the Bank's subsidiaries are wholly-owned, directly or indirectly (except in some cases for directors' qualifying shares).

The Bank's Parent - First National Boston Corporation

The Parent is a registered bank holding company with its principal office in Boston, Massachusetts. Its outstanding stock is publicly held and is listed and traded on the New York and Boston Stock Exchanges. The Parent has a substantial number of banking and financial subsidiaries many of which subsidiaries are directly held and many of which are held indirectly through various subsidiaries. Except as hereinafter mentioned, all of such subsidiaries of the Parent are wholly-owned, directly or indirectly (except in certain cases for directors' qualifying shares).

Exceptions Relating to the Bank

The Bank has a wholly-owned subsidiary, Boston Overseas Financial Corporation, which is a United States Edge Act corporation. This wholly-owned subsidiary has direct ownership interests in a number of financial entities organized under the laws of, and operating in, various foreign countries. Some of such entities are wholly-owned directly or indirectly. A number of such entities are partly-owned. Except in the instance mentioned below, the "outside" ownership interests in such partly-owned entities are held by one or more banks or other financial institutions organized and operating under the laws of foreign countries none of which are affiliates of the Bank or the Parent. In some

cases, the outside ownership interests are wholly or partly held by individuals who are foreign nationals who are not otherwise affiliated with the Bank or the Parent.

An indirectly wholly-owned subsidiary of the Bank is a 20% joint participant in a small Brazilian enterprise, the outstanding 80% interest in which is owned by a wholly-owned subsidiary of PHH Group, Inc., a publicly-held domestic corporation whose stock is traded and listed on a national securities exchange.

The assets of all such entities if considered in the aggregate, and if considered to be owned by a single subsidiary, would not constitute such subsidiary to be a significant subsidiary of the Bank or the Parent.

Exceptions Relating to the Parent

(A) The Parent, through a wholly-owned subsidiary, owns 50% of the outstanding stock of First National Computeristics, Inc., a Massachusetts corporation, the balance of whose outstanding stock is owned indirectly by Uniroyal, Inc., which is a domestic publicly-owned corporation whose common stock is traded and listed on a national securities exchange.

(B) Until recently, the Parent, through several separate single purpose indirectly wholly-owned subsidiaries, had been engaged in a tanker leasing program involving three 265,000 deadweight ton U.S. flag tankers. In August of 1980, the Parent entered into an agreement to sell all of its stock in said subsidiaries to Tenafly VLCC Holdings, Inc., a privately-held company, for notes guaranteed by Seatrain Lines, Inc., a publicly-held corporation whose stock is traded and listed on a national securities exchange; 49% of the stock of said single purpose subsidiaries has been sold and transferred to Tenafly and the remaining 51% of stock will be transferred to Tenafly at the conclusion of statutory waiting periods required under the pre-merger notification provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

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ROBERT W. MESERVE AND BENJAMIN H. LACY, REORGANIZATION TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR, and THE FIRST NATIONAL BANK OF BOSTON AND MALCOLM W. HALL, SUCCESSOR INDENTURE TRUSTEES, ET AL.,
RESPONDENTS.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents, who are the Trustees in Reorganization of the estate of the Boston and Maine Corporation, Debtor in pending railroad reorganization proceedings, and the Indenture Trustees under the Indenture pursuant to which the Debtor's first mortgage bonds are outstanding, respectfully submit this brief in opposition to the petition for a Writ of Certiorari filed herein by the Chesapeake and Ohio Railway Company, the Baltimore and Ohio Railroad Company and the Western Maryland Railway (the "Petitioners").

Opinion Below

The opinion of the Court of Appeals for the First Circuit is reproduced as Appendix A hereto (pp. A-1 — A-47).

Counterstatement of the Case

On March 12, 1970, an involuntary petition pursuant to Section 77 of the Bankruptcy Act (the "Act"), 11 U.S.C. §205 (1976), was filed against Boston and Maine Corporation (the "Debtor") in the United States District Court for the District of Massachusetts (the "Reorganization Court").[1] That petition was thereafter approved by the Reorganization Court and the Reorganization Trustees were appointed as such by Order dated April 24, 1970.

At the time of the filing of the involuntary reorganization petition, Petitioners had unsecured claims against the Debtor on account of the latter's alleged underpayment of per diem charges[2] in the period from August 1, 1953 to the date of the filing of the reorganization petition. During this period, the Debtor and others were contesting increased rates of per diem charges established by the Association of American Railroads (the "AAR"). By agreement between the Debtor and the proponents of the higher rates, including Petitioners, the Debtor in this period settled and paid interline per diem charges at the rates prevailing prior to the increase in accordance with AAR settlement rules, and the roads claiming the higher rates submitted open bills for the claimed difference. (B8). Petitioners claim an underpayment of $1,313,758.81 for the period August 1, 1953 to August 1, 1969[3] and an underpayment of

---

[1] Four insurance companies, known as the "Institutional Group", holding approximately 30% of all Debtor's outstanding first mortgage bonds, filed the involuntary petition after Debtor defaulted on its February 2, 1970, semi-annual interest obligation. *In re Boston and Maine Corp.*, 484 F.2d 369, 371 (1st Cir. 1973).

[2] A per diem charge is a charge which one railroad pays for cars of another while such cars are on the former railroad's line. The charge is payable to the car-owning railroad whether the car is filled with freight loaded on the car-owning railroad's line or elsewhere or whether the car is empty.

[3] This reflects the difference between what the Debtor paid during that period and what it would have paid if rates which the Interstate Commerce Commission had recommended in an advisory opinion as reasonable for that period had been adopted by the United States District Court for the Southern District of New York before which was pending the private contract action relative to the reasonableness of the per diem

$71,322. 91 for the period of August 1, 1969 through March 12, 1970.[4]

On or about March 28, 1977, almost seven years after the filing of the reorganization petition, Petitioners filed a petition with the Reorganization Court seeking an order directing the Trustees to pay in full their aforesaid pre-reorganization per diem claims. Thereafter, the Committee of Interline Railroads and others filed similar petitions. The Reorganization Trustees filed answers to these petitions which essentially denied that the Petitioners and others filing similar petitions were anything but general unsecured creditors without entitlement to payment of their pre-reorganization per diem claims. The Indenture Trustees also filed an answer opposing these petitions. Stipulations of matters bearing upon the issue were entered into by the Reorganization Trustees and each of the claimants who filed a petition for payment, including Petitioners. A copy of the stipulation with Petitioners, without exhibits (which consist primarily of Court and ICC decisions), is attached hereto as Appendix B. The Reorganization Court denied the relief prayed for in these petitions and, on appeal by Petitioners and others, that decision was affirmed by the First Circuit Court of Appeals. *In re Boston & Maine Corp.*, 456 F.Supp. 412 (D. Mass. 1978), *aff'd*, 600 F.2d 307 (1st Cir. 1979) (hereafter called the *"Per Diem Case"*).

On or about November 4, 1977, the Reorganization Trustees filed a petition requesting that the Reorganization Court approve their proposed classification of creditors and stockholders pursuant to §77(c)(7) of the Act. The proposed classification did not accord to per diem claims the full-payment priority which Petitioners had sought in the *Per Diem Case*. As initially proposed, such claims were ranked below those of general unsecured pre-

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rates established by the AAR. *Baltimore & O. R.R. Co.* v. *New York, N.H. & H. R.R. Co.*, 196 F. Supp. 724 (S.D.N.Y. 1961) (hereinafter called the *"New York Suit"*); *Chicago, B. & O. R.R. Co.* v. *New York, S. & W. Ry. Co.*, 332 I.C.C. 176 (1968) (hereinafter called the *"Rate Case"*).

[4] This reflects the difference between what the Debtor paid for that period and the per diem rates fixed prospectively for the post-August 1, 1969 period by the Interstate Commerce Commission in the *Rate Case*.

reorganization claims. Subsequently, the classification was amended to include the disputed per diem claims in the same class as general unsecured claims. On November 22, 1977, objections to the proposed classification were filed by the Petitioners, who claimed, *inter alia*, entitlement to "immediate payment in full" of their per diem claims on the grounds argued in connection with their prior petition for such relief heard by the Reorganization Court on November 15, 1977. Additionally, Petitioners claimed entitlement to priority for part of their claims under the so-called Six Months Rule and Necessity of Payment Rule.

The proposed classification and the Petitioners' objections thereto were heard by the Reorganization Court on November 13, 1978, approximately two months after that Court had denied Petitioners prior petition seeking full payment of the per diem claims.[5] Petitioners' appeal from such order was pending at the time of the hearing on classification.

On March 12, 1979, a little more than three weeks before the per diem appeal was argued in the Court of Appeals, the Reorganization Court entered its Memorandum decision in which it approved the Reorganization Trustees' proposed classification (as amended) and again rejected Petitioners' claims for a priority which would have required payment in full of their per diem claims. 468 F.Supp. 996 (D. Mass. 1979). An order consistent therewith was entered on March 19, 1979.

On June 15, 1979, the First Circuit Court of Appeals affirmed the Reorganization Court's denial of the per diem petitions, agreeing with the District Court's conclusion that there was no statutory basis for distinguishing pre-reorganization per diem claims from any other pre-reorganization claims, and finding nothing in the Act or in the jurisdiction exercised by the Interstate Commerce Commission (the "Commission") which would warrant an order requiring the Trustees to pay the per diem claims in full. 600 F.2d at 308.

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[5] The Reorganization Court's Memorandum of Decision and order denying the per diem petitions were entered on, respectively, August 31 and September 18, 1978.

On the Petitioners' appeal from the Reorganization Court's decision on the Trustees' classification, the Court of Appeals, on October 6, 1980, again affirmed the Reorganization Court's refusal to recognize a special priority for per diem claims which would require their payment in full.[6] With respect to the per diem claims arising in the period prior to August 1, 1969, the Court of Appeals held that these were not entitled to a full-payment priority for the reasons set forth by the Court in the *Per Diem Case*: these claims were essentially private claims no different from any other pre-reorganization unsecured claims. The Court also held that the *Per Diem Case* also disposed of all contentions that would justify a full-payment priority for those per diem claims which arose in the period after August 1, 1969, with the exception, in respect of those claims only, of the argument of unconstitutional taking. As to that contention, the Court ruled that the denial of a special priority in reorganization proceeding "neither denies an entitlement nor takes property or its use without compensation" (A.8) and that adherence to constitutional principles did not require the insulation from the risk of loss that would result from recognition of a super-priority inasmuch as insolvency losses were random and due to extrinsic factors and not the certain or necessary consequence of the pattern of regulation. *Id.* The court viewed the forty-day credit term provided in the AAR Settlement Rules as modest and probably as short as possible in light of business reality and further recognized that the accumulation of claims in this case was not the necessary consequence of the pattern or structure of governmental regulation. (A.10). The Court further stated that such risk of loss as might be incidental to the conduct of business was not unreasonable given Petitioners' in-

[6] Additionally, the Court reversed the Reorganization Court insofar as it failed to establish a class of creditors who may have priority under the Six Months Rule. (A.46). It did not, as Petitioners suggest, decide that any of the per diem claims were entitled to that priority, but rather remanded the case to the Reorganization Court for further proceedings. (A.47). The Respondents filing this Brief in Opposition have filed a Petition for a Writ of Certiorari as to this second aspect of the Court of Appeals' decision. Said Petition was docketed in this Court on January 14, 1981, docket no. 80-1182.

terest in through freight revenues derived from the process of interchanging cars with other carriers. *Id.* The Court concluded that no showing was or could be made that the regulations with respect to per diem, including the incidence of loss in reorganization cases arising from any required extensions of credit, resulted in a taking without just compensation. (A.11).

At no time in the litigation below have Petitioners claimed that either the Bankruptcy Act or the Interstate Commerce Act specifically provides that per diem charges for pre-reorganization rail car use must be given a priority over other claims against a railroad in reorganization. *In re Boston and Maine Corp.*, 456 F. Supp. at 414.

Both in their Statement of the Case and their Argument, Petitioners tend to exaggerate, if not mischaracterize, the scope of governmental action and regulation with respect to per diem charges. This exaggeration is evident in a comparison of the statement of facts in the Petition with the statement of facts contained in the decision of the First Circuit Court of Appeals in the *Per Diem Case*. Although it is true that in 1911 the Interstate Commerce Commission declared the system of car interchange which gave rise to per diem charges to be obligatory on carriers, it is equally true that long before that time railroads generally recognized that it was in their best interest to permit their cars which contained freight of their customers consigned to destinations on another railroad's line to pass onto the line or lines of other carriers rather than to have freight off-loaded at the end of the car owner's line and transferred to the car of the connecting carrier. (B.2); *Chicago, R.I. & P. Ry. Co.* v. *U.S.*, 284 U.S. 80, 90 (1931). The railroads' economic interest in meeting their shippers' through freight needs and the costliness of alternatives to car interchange obviously outweighed any risk of non-payment of per diem or possible disadvantage due to loss of control over the car after its destination was reached. In fact, the interchange of cars was not only an obligation but a right. The forty-day settlement terms established by the railroads certainly reduced the risk of loss.[7]

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[7] The Commission made these AAR settlement rules obligatory on all railroads in *Rules for Car-Hire Settlement*, 160 I.C.C. 369 (1930).

(A.10). Indeed, many suppliers in other industries would envy such short credit terms. The mutuality of the system also tended to produce a mutuality of interest in ensuring that the system worked without excessive disruption. It is true that at times when certain car owners experienced unusual demand on their lines for cars, the system failed to function smoothly. Such was the situation that prompted the decision in *Missouri & Illinois Coal Co.* v. *Illinois Central R.R. Co.*, 22 I.C.C. 39 (1911) and *Chicago, R.I. & P. Ry. Co.* v. *United States*, 284 U.S. 80 (1931). Interestingly enough, although the Commission in *Missouri & Illinois Coal Co.* determined that it had the power to enforce the maintenance of through routes by the interchange of cars, no order was entered in the case as it chose to rely

> upon the good faith of carriers under the law as herein presented to make such regulations for car interchange and for the maintenance of through routes involved as may be needed.

22 I.C.C. at 49.

Contrary to Petitioners' assertion, it is clear, as was recognized in the *Per Diem Case*, that from the start of the voluntary and general practice of interchanging cars until August 1, 1969, per diem rates were fixed not by the Commission but by private agreement among members of what was first called the American Railroad Association and later the AAR. 600 F.2d at 308.

Although the Esch Car Service Act (incorporated into the Interstate Commerce Act as 49 U.S.C. §§1(10)-(17)) indicated a power in the Commission to set per diem rates, until an amendment of Section 1(14) in 1966 (Public Law 89-403), there was substantial doubt as to the extent, if any, that the Commission could prescribe such rates. H. Rep. No. 1183, 89th Cong., 2nd Sess., 2 U.S. Code Cong. and Ad. News (1966), 2227, 2229; S. Rep. No. 386, 89th Cong., 1st Sess. at 6. In 1947, a three-judge district court had set aside a Commission order prescribing rates, on the ground, *inter alia*, that the Commission had no authority to prescribe rates for regulatory purposes. *Palmer* v. *United States*, 75 F. Supp. 63 (D.D.C. 1947).

On pages 10-11 of their Petition, Petitioners apparently suggest that in *Rules for Car-Hire Settlement*, 160 ICC 369, 165 ICC 495 (1930), the Commission fixed per diem rates. Petitioner made the same assertion in the *Per Diem Case* and the First Circuit rejected the same. 600 F.2d at 609.

As indicated on pages 6-9 of their Petition, Petitioners continue to mischaracterize the role of the Commission in the attempted resolution of the dispute over the per diem rate that began in 1953. This dispute precipitated two proceedings:

(1) a proceeding before the Commission for a determination as to the reasonableness of the increased rates (B.5); and, before that proceeding was finally concluded

(2) the *New York Suit*, in which various railroads, including Petitioners other than the Chesapeake and Ohio, sought to recover from the Debtor and others the new per diem charges established pursuant to the AAR agreements (B.8). As described by Judge Ryan in that case:

> The controversy revolves around the *contractual* obligation of defendants to pay the per diem rates established by three instruments: 'the Car Service and Per Diem Agreement,' 'the Plan of Organization' and 'Agreement No. 6.'

Baltimore & O. R.R. Co. v. *New York, N.H. & H. R.R. Co.*, 196 F.Supp. 724, 726 (S.D.N.Y. 1961) (emphasis added)

Although finding that the Debtor had withdrawn from those formal agreements, Judge Ryan, applying the principle of *quantum meruit*, entered partial summary judgment in favor of plaintiffs in an amount to be subsequently determined by him after receipt from the Commission of its advice as to what was just, fair, reasonable and non-discriminatory rates. 600 F.2d at 309. The Commission did subsequently render that advisory opinion with respect to the period August 1, 1953 to August 1, 1969 and thereafter discontinued the proceeding as to that period without entering any order of payment. As to the period commencing August 1, 1969, the Commission did prescribe per diem rates, which the carriers were ordered to pay.

Petitioners acknowledged in the stipulation between the parties that from 1953 to March 12, 1970 the Debtor and each of the Petitioners settled accounts in accordance with the AAR per diem rules and that Petitioners voluntarily entered into arrangements whereby they settled with the Debtor at the rates prevailing prior to the increase in 1953, accepting payment at those rates and billing the Debtor on open account for the difference between what the Debtor paid on a current basis and the higher amount claimed. (B.4). This was a private arrangement not dictated by governmental action or regulation. Moreover, as is more fully discussed below, this was not the only arrangement available to Petitioners to avoid or minimize a risk of loss.

What is clear from the foregoing, is that governmental action and regulation, at least so far as it involved per diem, reflected the consensus of those regulated as to what was in their best economic interest. Such regulation was lightly structured to maximize self-regulation and to foster the making of economic decisions by those regulated, with almost unlimited access to Court or Commission for redress of grievance, resolution of dispute or advice of an objective arbiter.

Summary of Argument

Petitioners now seek to have this Court review a decision of the First Circuit Court of Appeals determining that their pre-reorganization unsecured claims against the Debtor for per diem are not entitled to a special priority that would require their payment in full. Petitioners acknowledge that they seek a special or super-priority, inasmuch as neither the Bankruptcy Act nor the Interstate Commerce Act specifically provides for such a priority. Under the Bankruptcy Act there is nothing that would distinguish their per diem claims from other general unsecured claims against a debtor. 600 F.2d at 308.

The decision sought to be reviewed is, Respondents submit, the second decision denying the claimed priority rendered by the Courts in the reorganization proceedings. The first decision was rendered in the *Per Diem Case*. Petitioners did not seek review of

the Court of Appeals decision in that Case and, accordingly, the Reorganization Court's decision therein became final. Because the litigation in the classification case involving per diem essentially constituted the same cause of action or claim as was involved in the *Per Diem Case*, Respondents submit that Petitioners are barred by the principles of res judicata from now pressing the questions or issues presented on this Petition. To the extent that the two litigations are somehow viewed as involving different causes of action, Petitioners are estopped from asserting the second question raised on their Petition and their constitutional contention in respect of per diem claims accrued prior to August 1, 1969, all as a consequence of the determinations made in the *Per Diem Case*.

As to the Petitioners' contention that a denial of a special priority retroactively effects a taking of their cars without just compensation, there is nothing in the record that shows that the compensation they have received in connection with the interchange or loan of their cars is unjust in the context of their entire business or that the pattern of regulation, including that prevailing after August 1, 1969, resulted in an unconstitutional deprivation, considering the impact of regulation on Petitioners' entire business. Additionally, when one considers the nature of governmental action and regulation with respect to per diem during the relevant period together with what Petitioners did do and failed to do in the circumstances and the remedies available to Petitioners, one must conclude that any lack of just compensation for the use of their cars was not the consequence of governmentally compelled acts or regulations, much less the subsequent and foreseeable action of the Reorganization Court in establishing priorities among creditors. Indeed, Petitioners' voluntary extension of credit to the Debtor and their failure to secure that extension of credit bars or estops them from now claiming an unconstitutional taking.

Given the nature and extent of governmental action and regulation and of private interest and action in this case, the denial of a full-payment priority for per diem claims is not inconsistent with other decisions of this Court with respect to unconstitutional takings.

Because of the forty-day per diem settlement rule and changes in per diem regulation, including changes in the basis of car hire charges, it is most unlikely that the constitutional issue raised by Petitioners will recur. Even if that were a prospect, the present case is not an appropriate one in which to seek to avoid such recurrence in light of the facts pertaining to this case heretofore discussed.

This Court's review of the decision below denying the full-payment priority is not necessary to resolve the conflict between the First and Seventh Circuits or any alleged conflict between the First Circuit's decision and national transportation policy because those conflicts have been resolved by Congress in the Bankruptcy Reform Act of 1978. In the new Bankruptcy Code adopted by that Act, 11 U.S.C. §101 *et seq.*, Congress rejected the Seventh Circuit's decision in *In re Chicago, R.I. & P.R.R. Co.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied*, 429 U.S. 1092 (1977) (hereinafter called the "*Rock Island Case*"). Congress did so on the ground that the decision violated the principle of equality of treatment of creditors. 124 Cong. Rec. S17422 (daily ed. Oct. 6, 1978) (statement of Senator DeConcini). Obviously, in the judgment of Congress that principle had primacy over considerations of national transportation policy.

Even if these conflicts alleged by Petitioners were not deemed to have been resolved, it is clear that the case at bar may be distinguished in material respects from the *Rock Island Case* and does not provide an appropriate forum for dealing with the particular issues raised. Additionally, Petitioners' contention that national transportation policy is frustrated by the denial of the full-payment priority is without any foundation in fact. As previously noted, in 1970 material changes in per diem regulations were effected. Even if we assume that notwithstanding such changes there continues to exist the car shortage that prevailed in the 1950's and 1960's, it is quite clear that the grant of a super-priority will not materially alleviate that condition. Courts should not be called on to create aberations in bankruptcy law in an attempt to solve problems which should be resolved by the Congress.

Reasons for Denying the Writ of Certiorari

I. Petitioners Are Barred or Estopped From Continuing To Litigate the Questions Presented in Their Petition as a Consequence of the *Per Diem Case*.

Petitioners did not file a petition for certiorari from the decision of the First Circuit Court of Appeals in the *Per Diem Case*. The decision of the Reorganization Court in that case became final prior to the decision of the Court of Appeals which Petitioners now seek to have reviewed.

The *Per Diem Case* and the classification proceedings which resulted in the more recent Court of Appeals decision involve the same cause of action or claim so far as concerns the dispute over Petitioners' per diem claims. In both proceedings, Petitioners sought recognition of a full-payment priority for their per diem claims and in both cases the Reorganization Court and the Court of Appeals refused to recognize such a priority.

The Petitioners initiated the *Per Diem Case* by a petition which requested that

> the Court enter an order directing the payment by the Trustees of the Boston & Maine Railroad of all per diem balances incurred by the Boston & Maine Corporation in favor of the Petitioners prior to March 12, 1970.

At the argument before the Reorganization Court on the per diem petition, Petitioners' counsel stated that their petition

> seeks primarily the establishment of their right to a super priority for the per diem claims. The priority that transcends the Bankruptcy Act based upon the recent decision of the *Rock Island* case . . .
>
> I am asking for establishment of our right to a priority of the very highest order which will, when all of the determinations as to priority have been made, finally result in an order that the Trustees pay to us all pre-reorganization per diem claims. (*Per Diem Case* Joint Appendix, pp. 469-470)

It was the Reorganization Trustees' position that per diem claims were merely general unsecured claims against the Debtor and entitled to only the priority accorded such claims. *In re Boston and Maine Corp.* 456 F.Supp. at 414.

> It is also not disputed that neither the Bankruptcy Act nor the Interstate Commerce Act, 49 U.S.C. §1 *et seq.* specifically provides that per diem charges for pre-reorganization rail car usage must be given priority status over other claims against a railroad in reorganization.

Id.

In their brief to the First Circuit Court of Appeals from the Reorganization Court's denial of their per diem petition (filed February 14, 1979), after pressing the issues described in the second question presented on their Petition for Certiorari, Petitioners argued:

> In addition to the policy in favor of encouraging an increase in the national car supply, we urge upon the Court the basic equitable consideration that, unlike all other creditors in this reorganization, the car-owning railroads were required *by federal law* to lend their cars to the Boston and Maine. In obedience to that mandate, they continued to furnish cars regardless of the Boston and Maine's failing credit and its expressed intention not to pay the charges demanded by the car-owning railroads. The cost elements upon which per diem rates are based do not include a factor for bad debts so that a mandate to furnish cars without insuring compensation would have been confiscatory. (As to confiscation, see Page 26 of this Brief)

On Page 26 of that Brief is their discussion of *Chicago, R.I. & P. Ry.* v. *United States,* 284 U.S. 80 (1931). Maine Central Railroad Company, also an Appellant in the *Per Diem Case* argued in its brief to the Court of Appeals:

> To allow deferral of payments would raise serious Fifth Amendment problems.

At the argument before the Court of Appeals in the *Per Diem Case* (April 5, 1979), Petitioners more explicitly urged the constitutional question now appearing as the first question presented on their Petition for Writ of Certiorari. It is interesting to note that both their brief and argument to the Court of Appeals in the *Per Diem Case* followed the hearing before the Reorganization Court on the Trustees' classification petition and the objections thereto, including those of Petitioners. In their filed objections to the proposed classification, Petitioners had stated:

> As to that portion of their claims which represents per diem charges, they object to classification in ninth place and allege that they are entitled to immediate payment in full, all as more fully argued in connection with their Petition therefor heard by this Court on November 15, 1977.

Both in their brief and their argument to the Reorganization Court on November 13, 1978, Petitioners supported their objection to the Trustees' classification on the basis of the argument made in the *Per Diem Case* and further argued that the Fifth Amendment to the Constitution required full payment of their per diem claims.

In the *Per Diem Case*, the Reorganization Court held that there was no statutory basis for distinguishing pre-reorganization per diem claims from other general unsecured pre-reorganization claims, 456 F.Supp. at 416, and the Court of Appeals agreed, 600 F.2d at 308. The Reorganization Court found that the grant of a special priority for per diem claims would prejudice other unsecured creditors and could impair prospects of reorganization:

> On the other hand, to require immediate payment of these claims, *or even to accord them special priority*, would substantially reduce the assets of Debtor's estate available for pre-reorganization creditors, and could impair the financial condition of the estate in terms of its prospect for reorganization.

456 F.Supp. at 417 (emphasis added).

Neither the Reorganization Court nor the Court of Appeals found anything in the jurisdiction exercised by the Commission

or in considerations of national transportation policy that would support a priority for the per diem claims which would require their payment in full. 456 F.Supp. at 416-17; 600 F.2d at 311-13. In this respect, they explicitly rejected the special priority recognized by the Seventh Circuit in the *Rock Island Case* based on the primacy of Commission orders.[8] Additionally, the First Circuit Court of Appeals found support for rejecting the *Rock Island* rule in Congress's recent rejection of that rule on the basis that it violated the principle of equality of treatment of creditors. *Id.* at 312-13. See section 6, *infra*.

What is clear from the foregoing is that the *Per Diem Case* finally determined the issue as to whether the per diem claims were entitled to a special priority that would require their full payment.[9] Petitioners suggest, on page 22 of their petition, that this is not the case, but rather, that the First Circuit "required" two decisions to complete the disposition of per diem claims, and regarded the possibility of priority for per diem claims as remaining open after its decision in the *Per Diem Case*. In support of this, Petitioners cite *In re Boston & Maine Corp.*, 618 F.2d 173, at 140-41 (1st Cir. 1980). A careful reading of that case, however, does not suggest that the Court of Appeals viewed the question of a full-payment priority as remaining open. In the referenced portion of that decision, the Court of Appeals describes the reasons set forth by the Reorganization Court in its Memorandum for denying the request of first mortgage bondholders for a payment of interest. Among the reasons for such denial given by Reorganization Court was the possibility of "a reordering of priorities of the per diem claim of interline railroads, and the claims of creditors under the Six Months Rule and 'necessary [sic] of payment' rule, as a result of appellate review, . . ." *Id.*

Even assuming that in the quoted language the Reorganization Court was referring to a broader reordering of the priority of per

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[8] The holding in the *Rock Island Case* is further explicated by the Seventh Circuit in *In re Chicago, M., S.P. & P. R.R. Co.*, 632 F.2d 45 (7th Cir. 1980).

[9] The Reorganization Court, in its classification decision, obviously felt that its decision in the *Per Diem Case* disposed of the full payment priority issue. *In re Boston & Maine Corp.*, 468 F.Supp. 996, 999 (D. Mass. 1979).

diem claims than simply that involved in the Six Months Rule issue, such broader reordering was still possible because at the time of that decision[10], the *Per Diem Case* had not yet been decided by the Court of Appeals.

Apart from the foregoing, the Court of Appeals in the appeal from the classification order, acknowledges that its decision in the *Per Diem Case* is dispositive of all contentions raised by Petitioners except for their constitutional argument and that exception pertains only with respect to the per diem claims which accrued after August 1, 1969. (A.7). Although it is true that in the *Per Diem Case* the Court of Appeals did not explicitly address the Petitioners' constitutional argument, the Court's finding that per diem rates prior to August 1, 1969 were a matter of private agreement necessarily negates any contention of a governmentally compelled taking without just compensation with respect to the claims accrued prior to that date. Additionally, we respectfully disagree with the Court's assessment that its decision in the *Per Diem Case* did not dispose of the constitutional argument in respect of post-August 1, 1969 per diem claims. The Court correctly notes that its decision in the *Per Diem Case*

> dealt directly and necessarily with the underlying issues of statutory interpretation and with the contention that a priority in reorganization for per diem claims would better serve the interest of national transportation policy than would denying the priority.

(A.7)

It is clear from the decisions of both the Court of Appeals and the Reorganization Court in the *Per Diem Case* that each was addressing and deciding an issue of priority in determining whether any basis existed for ordering full payment of the per diem claims as prayed for by Petitioners. That neither Court directly addressed the Petitioners' constitutional argument does not mean that the constitutional issue as well as other issues which were raised or could have been raised by Petitioners in the *Per Diem Case* were not barred by principles of res judicata in Petitioners' second at-

[10] May 22, 1979.

tempt to establish a full-payment priority in the context of the classification proceeding. The determination on the merits in the *Per Diem Case* bars relitigation in the classification proceedings of the issues which were raised or could have been raised in the *Per Diem Case*. *E.g.*, *Commissioner of Internal Revenue* v. *Sunnen*, 333 U.S. 591, 597 (1948); *Cromwell* v. *County of Sac*, 94 U.S. 351 (1876); *Pepper* v. *Bankers Life & Cas. Co.*, 414 F.2d 356, 357-58 (8th Cir. 1969); *Restatement of Judgments* ch. 3, Introductory Note, §§ 47, 48 (1942).

Even if one were somehow to treat the litigation in the classification proceedings relative to the per diem priority as a different cause of action or claim from that asserted in the *Per Diem Case*, Petitioners would still be estopped or barred from relitigating in the classification proceeding questions of fact litigated and determined in the *Per Diem Case*. *E.g.*, *Commissioner of Internal Revenue* v. *Sunnen*, *supra*, at 598; *Mercoid Corp.*, v. *Mid-Continent Co.*, 320 U.S. 661, 671 (1944); *Restatement of Judgments* §§ 68, 69, 70 (1942). Because both litigations arise out of the same subject matter or transaction, Petitioners would be estopped or barred from relitigating in the classification proceedings questions of law litigated and determined in the *Per Diem Case*. *E.g.*, *Seguros Tepeyac, S.A.* v. *Jernigan*, 410 F.2d 718 (5th Cir.), *cert. denied*, 396 U.S. 905 (1969); *Saylor* v. *Lindsley*, 391 F.2d 965 (2d Cir. 1968); *In re Orbitec Corp.*, 392 F.Supp. 633 (S.D.N.Y. 1975); *Restatement of Judgments* §70 (1942). These principles bar Petitioners from raising the second question presented on their Petition and preclude raising a question of unconstitutional taking at least as to the portion of their per diem claims which arose in the period prior to August 1, 1969 inasmuch as it has been finally determined in the *Per Diem Case* that the compensation for the so-called loan of their freight cars was not fixed during this period by public or governmental action.

Because the questions presented on this Petition have already been litigated in the *Per Diem Case* and the decision in that case is final, we respectfully submit that this Court should not grant the Petition for Writ of Certiorari.

II. The Denial of a Full-Payment Priority for Petitioners' Per Diem Claims Does Not Effect a Public or Governmentally Compelled Taking Without Just Compensation.

A. *Petitioners Have Not Shown That if They Are Not Accorded a Full-Payment Priority for Per Diem the Compensation they Will have Received in Connection with their Loan of Cars is Unjust in the Context of their Entire Business or that in that Context, Regulation Caused a Loss.*

Petitioners have acknowledged that they did receive payment from the Debtor for per diem charges in the period August 1, 1959 through March 12, 1970 at rates prevailing prior to the AAR increase in 1953. (B8). The Petitioners' per diem claims are claims for additional compensation and are now measured by what the Commission has recommended as reasonable in an advisory opinion to the United States District Court in the *New York Suit*. No judgment has been entered by that Court establishing the reasonable rate. (B7).

Petitioners argue that if their per diem claims are not now accorded a full-payment priority, they will have received less than adequate or just compensation for the interchange or ~~loss~~ of their loan cars because the compensation actually received was at rates that did not reflect a factor for bad debt losses. Nothing in the record below establishes that the Petitioners would in fact suffer any material economic loss absent recognition of a full-payment priority. It has not been established that risk of loss was an impermissible factor in determining per diem or that established per diem rates did not reflect such risk. More importantly, it has not been shown that established freight tariffs did not reflect a factor for bad debts. Indeed, because freight tariffs normally reflect a profit factor, it is not unreasonable to expect that tariffs included factors for such losses as credit losses on per diem. Moreover, as the interchange or loan of cars was viewed as necessarily in aid of through traffic, *Missouri & Illinois Coal Co., supra*, at 49, one would normally expect that the burden of a credit loss on account of non-payment of per diem would be passed on to shippers by means of freight tariffs and charges.

Additionally, it should be noted that Petitioners recover fully the cost of their cars through depreciation regardless of whether per diem is paid. Such payments really constitute additional income to the car owner and, we believe, were primarily designed to avoid granting the non-car owning roads windfall benefits by requiring them to pay (prior to the adoption of incentive per diem in 1970) a charge which they would have incurred had they owned the car. Such windfall benefits became possible when the railroads recognized that in order to realize the substantial benefits of through traffic revenues, it was in their respective economic interests to permit the interchange of cars.

The possible windfall to non-car owners and the possible risk of loss of per diem income were very much random and relatively insignificant aspects of each railroads' business when weighed against the benefits of car interchange and the cost of alternatives. Whether Petitioners received adequate compensation for what they describe as the mandatory loan of their cars cannot possibly be measured only in terms of what they did and did not receive from the Debtor in terms of per diem. This is particularly so in the context of a constitutional challenge, as the First Circuit correctly points out in the decision below. (A8-9). That Petitioners themselves shared this perspective may be inferred from the fact that they voluntarily chose to accept per diem payments at the old rate, and bill for the balance rather than take other action available to them. See section 2B, *infra*. In this larger sense, Petitioners must have viewed the per diem payments actually received from the Debtor and the Debtor's promise to pay any additional sum found to be due, as full and just compensation for car usage and, indeed, for what was also in fact a profitable *right* to interchange cars.

B. *If Petitioners Are Denied a Full-Payment Priority and Have Not Received Adequate Compensation for Permitting Their Cars to Move on the Debtor's Line, That Lack of Adequate Compensation is Not a Consequence of Government Action or Regulation.*

As previously noted, Petitioners base their constitutional argument on the allegation that if they are not paid in full they will

have been forced, after the fact, to loan cars to the Debtor at per diem rates which did not reflect a factor for bad debt loss. That allegation mischaracterizes the degree of government compulsion involved. At best, Petitioners can claim that they were required to interchange their cars and accept settlements in accordance with AAR rules. Even in this respect it is quite telling that in the decision which declared interchange obligatory, the Commission refrained from entering any enforcing order. *Missouri & Illinois Coal Co., supra,* at 49. It has already been established that at least for the period prior to August 1, 1969 the Commission did not fix per diem rates. 600 F.2d at 308-09. The adequacy or fairness of compensation during this period was a private matter among the railroads. Accordingly, compensation so determined cannot provide a basis for Petitioners' constitutional attack. There is nothing in fact or in law which states that prior to August 1, 1969 the railroad industry was not free to reflect in per diem rates a factor for risk of nonpayment if such a risk was not otherwise accounted for. Because during this period rates were a matter of private contract, Petitioners cannot now utilize an alleged inadequacy in such rate-making as the basis for claiming a governmentally compelled taking without just compensation.

With respect to the per diem claims for the period of August 1, 1969 through March 12, 1970, Petitioners were parties to the proceedings before the Commission which resulted in the Commission's fixing rates for that period and thereafter. *Chicago, B. & Q. R.R. Co.* v. *New York, S. & W. Ry. Co.*, 332 I.C.C. 176 (1968). No suggestion has been made that it would have been improper to reflect in the rates so prescribed a factor for credit loss to the extent that such factor was not otherwise accounted for. There is no evidence that Petitioners sought the inclusion of such a factor or objected to its absence in the rates ultimately prescribed, if indeed it was absent. That Petitioners did not seek inclusion of such a factor is highly unusual in light of their present argument insofar as they have consistently claimed that during this period they were aware of the Debtor's precarious financial situation. Thus, even with respect to post-August 1, 1969 per diem claims, Petitioners are not entitled to now rely on the nature of the per diem rate as a basis for their constitutional challenge.

As previously noted, during the contest over per diem charges, Petitioners entered into an agreement with the Debtor pursuant to which the former agreed to accept payment at the old rate and accept the promise of the Debtor to pay the difference between that rate and any higher rate that might ultimately be established as reasonable. (B8); *Baltimore & O.R.R. Co.* vs. *New York N.H. & H.R.R. Co.*, 196 F.Supp. 724 at 736-39. That cash and promise to pay — essentially a promissory note — constituted full payment for all of the per diem that might be due. On its face, the consideration for the loan of Petitioners' cars was full and fair. Simply because application of established priorities in a subsequent reorganization results in all or a portion of that note being uncollectible does not render the compensation inadequate on a *nunc pro tunc* basis. The Petitioners made a voluntary extension of credit for part of what they claimed was due; they were not required to extend such credit. Indeed, the per diem settlement rules required the submission of car usage reports within forty days after the end of the month in which the car usage occurred and required payment thereafter of sight drafts for the net balance owing. (B4). The Constitution does not insulate creditors from the consequences of their own credit judgments or from their failure to seek security for their claims.

At no time during the period when they were extending credit to the Debtor did Petitioners have any reason to believe that their claim to any additional sums would be entitled to full payment notwithstanding intervening bankruptcy. Indeed, their experience in other railroad reorganizations indicated the contrary. *See, In re New York, N.H. & H.R.R. Co.*, 278 F. Supp 592, 607 (D. Conn. 1967). In that case, the per diem creditors did not claim a full-payment priority but only a priority under the Six Months Rule; and that lesser priority was denied them.

Moreover, nothing in the law during this period precluded alternative arrangements which might have insured full payment in the event of the Debtor's bankruptcy, such as the creation of an escrow fund or the furnishing of a bond or collateral. If such alternative arrangements could not be made voluntarily, Petitioners could well have sought to require such arrangements either in the

New York Suit or by pursuing the remedies provided under what was then sections 13(1) and 16(12) of the Interstate Commerce Act. The very case which Petitioners cite for the proposition that their cars could not be taken without just compensation was a 1931 case. *Chicago, R.I. & P. Ry. Co.* v. *United States*, 284 U.S. 80 (1931). That case established that the obligation to interchange cars was not so absolute and unconditional as to require its continuance in the face of an unconstitutional taking. Certainly, the case pointed the way to relief from the coercion and taking which is now alleged and which Petitioners must have considered imminent in light of what they say was their perception of the Debtor's financial condition.

In fact, over a period of 17 years no action was taken by Petitioners to secure their voluntary extension of credit. If anything was the proximate cause of allegedly inadequate compensation, it was not the action of the Reorganization Court in denying Petitioners a super-priority, but their own voluntary action in granting to the Debtor unsecured credit in the amount of what is now their claim. Though the interchange and loan of cars may have been governmentally compelled, that extension of credit and Petitioners' forebearance from acting to secure or otherwise protect themselves was not governmentally compelled. In light of Petitioners' conduct, they were no different from other pre-petition claimants who extended credit to the Debtor. Under these circumstances, any failure of just compensation must be viewed as a judgmental error on the part of the Petitioners and not a constitutionally significant taking.

III. Petitioners, by Their Course of Conduct, Are Barred and Estopped from Claiming That the Failure To Accord Their Per Diem Claims a Full-Payment Priority Effects a Taking Without Just Compensation.

The history of Petitioners' conduct described in the preceding section, and, in particular, Petitioner's failure to avail themselves of existing remedies to avoid anticipated or foreseeable adverse consequences of their extension of credit, requires a conclusion that Petitioners have waived and are

now barred or estopped from asserting any constitutional challenge to the Reorganization Court's classification order. *The New Haven Inclusion Cases*, 339 U.S. 392 (1970); *Yakus* v. *United States*, 321 U.S. 414, 443-45 (1943). *See*, *McDonough* v. *Hardware Dealers Mut. Fire Ins. Co.*, 448 F.2d 870 (1st Cir. 1971); *Trager* v. *Peabody Redevelopment Authority*, 367 F.Supp. 1000 (D. Mass. 1973); *Redgate* v. *Boston Redevelopment Authority*, 311 F.Supp. 43 (D. Mass. 1969).

IV. The Decision Below Is Consistent With Decisions of This Court on the Taking of Property Without Just Compensation.

Respondents respectfully submit that for the reasons set forth in Section 2 above, there was no governmentally compelled taking without adequate compensation. Even if we were to assume relative to the claims arising in the period after August 1, 1969, when per diem rates were prescribed by the Commission, that (1) those rates did not reflect a factor for risk of loss, (2) that on account thereof, per diem payments alone did not constitute adequate compensation for the cars and (3) the considerations set forth in Sections 2B and 3, *supra*, are to be ignored, the failure to grant a full-payment priority did not effect an unconstitutional taking under the decisions of this Court. In *Baltimore & O.R.R. Co.* v. *U.S.*, 345 U.S. 146 (1953), this Court determined that one aspect of the regulatory pattern and the particular consequence of that aspect are not controlling as to whether there has been a taking for public use without just compensation. In *Baltimore & O.R.R. Co.*, the fact that carload rates on certain kinds of produce was not compensatory was not conclusive as to whether there was an unconstitutional taking, as long as the regulations did not result in a loss in the railroad's overall business.[11] This thinking is partic-

[11] The teaching of this case has been followed in the decisions of lower courts cited by the First Circuit Court of Appeals in the decision below: *Western Airlines, Inc.* v. *CAB*, 495 F.2d 145, 152-53 (D.C. Cir. 1974); *Indiana Harbor Belt R.R.* v. *U.S.*, 510 F.2d 644, 650 (7th Cir.), *cert. denied*, 422 U.S. 1042 (1975); *Government of Guam* v. *FMC*, 329 F.2d 251, 254, (D.C. Cir. 1964); *Pan American World Airways* v. *CAB*, 256 F.2d 711 (D.C. Cir. 1958).

ularly applicable with respect to per diem regulations for the reasons discussed in Section 2A of this brief. The interchange of cars was not only an obligation but also a right having substantial value. That fact can be readily inferred from the general adoption of the practice prior to any governmental mandate, (B2), *Chicago R.I. & P.R.R. Co.* v. *U.S.*, 284 U.S. 80, 90 (1931), and its continuance without the need of any significant governmental enforcement action. Because car interchange and usage are an intrinsic part of through freight business, a constitutional attack on the classification as it retroactively and peripherally affects per diem rate determinations cannot be sustained absent a showing that the entire body of regulations, including those with respect to freight rates, worked an overall loss or deprivation.

The cases cited by Petitioners on pages 16 to 17 of their brief are not inconsistent with the decision below. *Kaiser Aetna* v. *U.S.*, 444 U.S. 164 (1979), involved an attempt by the government to impose a public servitude or easement without any compensation at all. Similarly, the regulations at issue in *Chicago, R.I. & P.R.R. Co.* v. *U.S.*, 284 U.S. 80. (1931), granted the short lines two days' free time for interchange of loaded cars and relieved them of any per diem charges for coal cars received for loading with coal. In *Chicago, M. & S.P.R.R. Co.* v. *Wisconsin*, 238 U.S. 491 (1915), the Court declared unconstitutional a state statute penalizing a railroad for taking down an unengaged upper berth if the lower berth was occupied. Each of the three cases involved a taking without any provision for compensation, one that was readily perceived as arbitrary and unreasonable. The case at bar has none of these characteristics. While the interchange of cars was mandatory, they were not required to be loaned without adequate compensation. Indeed, for the period prior to August 1, 1969, the carriers were obligated to establish reasonable and just rates and, as previously indicated, nothing precluded them from establishing rates which reflected a factor for credit losses. Petitioners did not contest the rates prescribed for the period subsequent to August 1, 1969, but indeed they participated in the process which resulted in those rates. Unlike the situation in *Kaiser Aetna*, Petitioners were fully aware of the credit risk involved in their claims against the

Debtor. Moreover, in each of the cases cited by the Petitioners there was a very real loss suffered as a direct and necessary consequence of government action. Such is not true in the case at bar, where Petitioners rely on the retroactive effect of what the First Circuit Court of Appeals has properly referred to as the extrinsic factor of a Reorganization Court's classification of claims in a manner which was wholly foreseeable by Petitioners at least as far back as 1953, when their claims began to accrue.

In light of the foregoing, we respectfully submit that the decision below is consistent with the decisions of this Court.

V. The Petition Does Not Present an Important Constitutional Issue Which Is Likely to Recur.

Petitioners contend that the constitutional issue will arise under the new Bankruptcy Code, 11 U.S.C. §101 et seq. The recurrence of such questions as raised by the Petitioners is quite unlikely.

Although section 1166 of the Code, 11 U.S.C. §1166, requires Court approval of, *inter alia*, any Commission order which would require the estate's payment of per diem, it is quite clear from the legislative history of this section and, in particular, the statements by legislative leaders, that a Reorganization Court may not properly approve a payment of pre-petition per diem because such payment would violate the expressed intent of Congress that pre-petition per diem and other interline claims be treated on the same basis as other general unsecured claims against a debtor. 124 Cong. Rec. S17422 (daily ed. Oct. 6, 1978) (Statement of Senator DeConcini). Notwithstanding the foregoing, the advent of incentive car hire rates in 1970 and the obvious unlikelihood that a car owner would permit its per diem claims to accumulate for any material period in excess of the forty-day settlement limit make it improbable that a constitutional issue is likely to recur.

Additionally, if there were a prospect that a constitutional issue might arise in respect of the non-payment of per diem claims in reorganization proceedings, it may fairly be said that the case at bar is not the proper case for resolving such an issue in light of the issues of res judicata, estoppel and waiver of rights necessarily involved herein and the nature of the per diem charges which are the subject of Petitioners' claims.

VI. BOTH THE CONFLICT BETWEEN THE FIRST AND SEVENTH CIRCUIT COURTS OF APPEALS AND ANY CONFLICT BETWEEN THE PRIORITIES COGNIZABLE IN REORGANIZATION PROCEEDINGS AND CONSIDERATIONS OF NATIONAL TRANSPORTATION POLICY PURPORTING TO JUSTIFY A SPECIAL PRIORITY HAVE BEEN RESOLVED BY CONGRESS IN THE BANKRUPTCY REFORM ACT OF 1978.

In the *Per Diem Case*, both the Reorganization Court and the First Circuit Court of Appeals rejected the decision of the Seventh Circuit Court of Appeals in the *Rock Island Case*. In *Rock Island*, the Seventh Circuit accorded to pre-petition per diem claims a special full-payment priority, holding that under Section 77(c)(2) of the Bankruptcy Act[12] the powers and orders of the Commission with respect to per diem[13] had primacy over the powers of the Reorganization Court to establish the priority of claims. The Court viewed such primacy as being required by the needs of national transportation policy. 537 F.2d at 912. The First Circuit Court of Appeals disagreed with the Seventh Circuit Court on a number of grounds. The First Circuit Court found support for its rejection of the Seventh Circuit analysis in Congress' specific refusal to incorporate into the new Bankruptcy Code the rule of the *Rock Island Case*. 600 F.2d at 312-13. Section 1168 of the original Senate version of the new Code applied the *Rock Island* rule.

§1168 *Effect of Other Laws and Regulations.*

> The trustee shall be subject to the Interstate Commerce Act (49 U.S.C. §1 et seq.), except as provided in this chapter, and to all lawful orders of the Commission . . . to the same extent as would the debtor if a petition commencing a case under this subchapter had not been filed, except that — (1) any such order that would require the expenditure, or the incur-

[12] To the extent here relevant, this section gives the reorganization trustees the power to operate the business of the debtor railroad "subject to the control of the judge and the jurisdiction of the Commission".

[13] As previously indicated, the Commission, in the *Rate Case*, had generally ordered all railroads to pay the per diem charges fixed for the period subsequent to August 1, 1969. 332 I.C.C. at 259.

> ring of an obligation for the expenditure, of money from the estate is not effective unless approved by the Court: *Provided, however*, that the payment pursuant to statutory, Interstate Commerce Commission, or recognized settlement procedures of the net balances owed by the debtor to other carriers on its interline accounts (including . . . per diem . . .), or pursuant to Interstate Commerce Commission orders of general applicability shall not require the approval of the court . . .

S.2266, 95th Cong., 2d Sess. 552

The Senate comment on this provision states that the debtor would have to pay in cash, without the necessity of court approval, current balances of per diem charges for periods both prior and subsequent to the filing of the petition. S. Rep. No. 95-989 at 134.

The original House version of the new Code contained an alternative section, then §1165, which ultimately was adopted as §1166 of the final Act. H.R. 8200, 95th Cong., 1st Sess.

> §1165 Except with respect to abandonment under Section 1170 of this title, or merger, modification of the financial structure of the debtor, or issuance or sale of securities under a plan, the trustees and the debtor are subject to the provisions of the Interstate Commerce Act . . . but (1) any such order that would require the expenditure, or the incurring of an obligation for the expenditure, of money from the estate is not effective unless approved by the court; and (2) the provisions of this chapter are subject to section 601(b) of the Regional Rail Navigation Act of 1973 (45 U.S.C. 791(b)).

H.R. 8200, 95th Cong., 1st Sess. 524.

The House comment on this section states that "the orders of the ICC are not effective if the order would require the expenditure . . . of money from the estate, unless approved by the court . . . . ." H.R. Rep. No. 95-595, at 423.

The statements by legislative leaders made clear the reason why the Senate version of this section was rejected in favor of the House version:

> Section 1166 of the House amendment is derived from sections 1164 and 1165 of the House bill. An alternative proposal contained in section 1168(1) of the Senate bill is rejected *as violative of the principle [of] equal treatment of all creditors under title 11.*

124 Cong. Rec. S17422 (daily ed. Oct. 6, 1978) (Statement of Senator DeConcini) (emphasis added).

We respectfully submit that this outright rejection of the *Rock Island Case* has put an end to the conflicts referred to in the second question presented on the Petition and in Part II of Petitioners' argument. Because Congress ultimately is the arbiter of issues of national transportation policy, U.S. Const. art. 1, §8, we have in this legislative action an authoritative statement that considerations of national transportation policy, including matters of car supply and car service, do not justify a departure from the equal treatment of creditors or provide a basis for limiting the jurisdiction of a reorganization court to apply traditional priorities to unsecured pre-petition per diem and other interline claims. By rejecting Section 1168 of the Senate bill, Congress has made an explicit and authoritative statement that there is nothing in national transportation policy that justifies treating per diem claims any differently than other general unsecured claims against a debtor.

Because these matters have been directly resolved by Congress, it is unlikely that a priority will ever again be asserted for per diem claims on the basis suggested in Part II of Petitioners' argument.

VII. Even if the Conflict With the *Rock Island Case* Were Not Resolved by Congress, the Facts of This Case Are Sufficiently Different From Those in the *Rock Island Case* as to Warrant Denial of the Petition.

In the *Rock Island Case*, the per diem claims which were at issue arose in the month in which the reorganization petition was filed and the two months prior thereto. Most of those were settleable for the first time under the AAR rules after the filing of Rock Island's reorganization petition on March 17, 1975. Only the January 1975 claims were first due to be presented prior to the filing of that petition and even those could have been filed five days

prior to the filing date. Additionally, all of the per diem claims in *Rock Island* were at rates which were prescribed by the Commission and which the Commission had ordered the railroads to pay. In the case at bar, the Petitioners' claims are claims for underpayments. They arose with respect to settlements made in accordance with AAR rules on a current basis, as the parties have stipulated, and over a seventeen-year period. Also, as determined in the *Per Diem Case*, 95% of those claims do not arise as a consequence of Commission-prescribed rates or involve an order of the Commission to pay. 600 F.2d at 308-09. The claims are founded in private contract or *quantum meruit*. In view of these material differences, this is not an appropriate case in which to attempt to resolve any residual conflict between the First and Seventh Circuits which has not heretofore been resolved by Congress.

VIII. REVIEW OF THE DECISION BELOW IN LIGHT OF NATIONAL TRANSPORTATION POLICY IS INAPPROPRIATE WHEN IT IS UNLIKELY THAT TRANSPORTATION NEEDS WOULD BE SERVED BY THE GRANT OF A FULL-PAYMENT PRIORITY AND WHEN ANY SUCH NEEDS MAY MORE EFFECTIVELY BE SERVED BY CONGRESS.

Petitioners suggest that the grant of a full-payment priority for per diem claims will serve national transportation policy. While their argument is expressly and primarily addressed to the redressing of old wrongs, they seem to imply that the full-payment priority will have a material and salutary effect on a rail car shortage. They do not say that they and others in their position would buy more freight cars than they otherwise would buy if the per diem claims were fully paid. Perhaps to the contrary, on page 28 of the Petition they tell us they have "paid more than their fair share of the cost of the national fleet of railroad freight cars . . ."

There is not in the record of this case current information as to the national inventory of freight cars. The transportation and freight car needs referred to by Petitioners prevailed during the 1950's and 1960's. As a response, in 1970 significant changes were made in per diem regulations. Incentive charges for car hire were established. *Incentive Per Diem Charges*, 337 I.C.C. 183 (1970). Additionally, a change was made to facilitate the return of empty cars to their owners. At least as of December, 1973, it appeared

that those changes had not effected a significant reduction in the railcar shortage. A 1973 Senate report characterized the railcar shortage as one of increasing severity and as one which demanded a legislative solution. S. Rep. No. 93-601, *reprinted in*, [1973] U.S. Code Cong. & Adm. News 3252-53.

If there is still a rail car shortage and there are rail car needs of the magnitude reflected in this Senate report, even without adjusting for inflation it is quite obvious that requiring railroads in reorganization to pay pre-reorganization per diem in full would provide no material amelioration of that problem. As suggested in the report, the problems can only effectively be addressed by Congress. Respondents believe that a review of the decision below in terms of national transportation policy, while well-intentioned, would at best be a speculative effort. Such an effort would not warrant a departure from the fundamental principle of equality of treatment of creditors and, we respectfully submit, should not be undertaken.

CONCLUSION

For the reasons hereinabove set forth, this case does not present an appropriate opportunity for the Court to resolve the questions presented on Petitioners' Petition. There is no conflict between the decision below as it affects those questions and decisions in other Circuits which have not heretofore been resolved. There is no conflict between the decision below in respect of those questions and decisions of this Court.

Respondents respectfully submit that a writ of certiorari should not be granted as requested by Petitioners.

Respectfully submitted,

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APPENDIX A

United States Court of Appeals
For the First Circuit

No. 79-1230

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
APPELLANTS.

No. 79-1231

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

MAINE CENTRAL RAILROAD COMPANY, ET AL.,
APPELLANTS.

No. 79-1234

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

PENN CENTRAL CORPORATION,
APPELLANT.

No. 79-1235

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

CANADIAN PACIFIC,
APPELLANT.

No. 79-1236

IN RE
BOSTON AND MAINE CORPORATION,
DEBTOR,

EASTERN ASSOCIATED COAL CORPORATION,
APPELLANT.

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[HON. FRANK J. MURRAY, *Judge*]

Before
KUNZIG,* *Judge, U.S. Court of Claims*
BOWNES, *Circuit Judge*
DOOLING,** *Senior District Judge*

Entered October 6, 1980

John T. Collins, with whom *Sherburne, Powers & Needham* was on brief, for Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company and Western Maryland Railway, appellants.

Paul B. Galvani, with whom *Reed Witherby* and *Ropes & Gray* were on brief, for Maine Central Railroad Company and Portland Terminal Company, Appellants.

George W. McLaughlin for Canadian Pacific, appellant.

Philip Burling, with whom *Peter A. Fine* and *Foley, Hoag & Eliot* were on brief, for Eastern Associated Coal Corporation, appellant.

Robert M. Gargill, with whom *Zdislaw W. Wieckowski, Choate, Hall & Stewart*, and *Charles W. Mulcahy* were on brief, for the Trustees of the Boston and Maine Corporation, Debtor, appellees.

Joseph H.B. Edward, with whom *Bingham, Dana & Gould* was on brief, for the First National Bank of Boston and Malcolm W. Hall Successor Trustees, under First Mortgage Indenture Dated December 1, 1919 of Boston and Maine Corporation, appellees.

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* Sitting by designation.

** Of the Eastern District of New York, sitting by designation.

DOOLING, D.J.

The present appeals[1] in this railroad reorganization case challenge the district court's order, 468 F. Supp. 996 (D. Mass. 1979), determining the priorities of the creditors and stockholders in the reorganization of the Boston and Maine Corporation. Railroads which, as required by the Interstate Commerce Act and the cases decided under it, have interlined freight cars with the Boston & Maine appeal from the district court's refusal to accord their claims for per diem charges for cars furnished in the periods August 1, 1953, to July 31, 1969, and August 1, 1969, to March 12, 1970, such a priority in the classification of creditors as would assure full payment of the claims. The interlining railroads and Eastern Associated Coal Corporation appeal also from the district court's refusal to establish a separate class of creditors, to be accorded priority as "six months creditors," for the railroads' claims for per diem car hire, car repair, loss and damage, and freight overcharges for the six months preceding the filing of the involuntary petition against the Boston and Maine on March 12, 1970, and for the Coal Corporation's claim for diesel fuel furnished in the same six months period.

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[1] The appeals of the Committee of Interline Railroads and of Trailer Train Co. have been withdrawn. No briefs have been submitted in support of the appeals of Penn Central Transportation Company and Atchison, Topeka and Sante Fe Ry. The appeals of the Chesapeake and Ohio Railway Company, et al., and of Canadian Pacific present the issues concerning the classification of the per diem claims of the interlining railroads for the period August 1, 1953, through July 31, 1969, as well as of the railroads' claims for per diem car hire, car repairs and loss and damage for the six months preceding the date on which the involuntary petition was filed against the Boston and Maine. The appeals of Maine Central Railroad Company and Portland Terminal Company and of Eastern Associated Coal Corporation relate to the classification of claims for per diem car hire, freight loss and damage and overcharge, car repairs, and diesel fuel for the six months preceding the filing of the petition.

I

The railroads' per diem claims, aggregating $8,582,000, are described in Chief Judge Coffin's opinion for this court, 600 F.2d 307 (1st Cir. 1979), affirming the district court's refusal, 456 F. Supp. 412 (D. Mass. 1978), to order immediate payment of the per diem charges before payment of all other unsecured pre-reorganization claims.[2] On that appeal this court rejected the contention that because the trustees' operation of the Boston and Maine is subject to the jurisdiction of the Interstate Commerce Commission, *see* former Bankruptcy Act § 77(c)(2), 11 U.S.C. § 205(c)(2) (1976), and because the ICC has ordered payment of specific per diem rates at specific settlement times, neither the trustees nor the court have discretion to defer payment of the pre-petition per diem charges. 600 F.2d at 308. This court concluded that the ICC had not exercised its statutory power, 49 U.S.C. § 1(14)(a) (1976), to fix the rates for per diem settlements for the period August 1, 1953, to August 1, 1969, and that, so far as concerned the period after August 1, 1969, following the ICC's entry of a per diem rate order, the general power of the ICC to supervise the trustees' operation of the railroad did not outweigh the fundamental power of the reorganization court to set priorities for payment of pre-reorganization claims, Bankruptcy Act §§ 77(b), (c)(7), (l), and to schedule payment of such claims consistent with the need to conserve assets for rehabilitation of the debtor. 600 F.2d at 309-10. The court added that the 1968 ICC order that interlining railroads pay specific per diem charges, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, 332 I.C.C. 176, 241, 333 (1968), was an order of general application, and that, since non-payment of the per diem claims violated no specific order directed to the reorganization trustees, the remedial provisions of Section 1(17)(a) of the

[2] The district court decision recounts the sequence of proceedings leading to the ICC's fixing of per diem rates in 1968. *See* 456 F. Supp. at 413 n.2.

Interstate Commerce Act[3] could not be invoked. 600 F.2d at 312. The court observed that, fundamentally, the specific duty to pay the per diem charges due for the pre-reorganization period had been a duty of the railroad, and, after the filing of the petition, those charges became claims against the debtor, not claims against the trustees; the specific duty of the trustees, as operators of the railroad, to pay per diems was limited to the per diems incurred by the trustees in their operation of the road.[4] The court rejected the contrary reasoning of *In re Chicago, R.I. & P.R.R.*, 537 F.2d 906 (7th Cir. 1976), *cert. denied*, 429 U.S. 1092 (1977), and indicated agreement with the result reached in *In re Penn Central Transportation Co.*, 486 F.2d 519 (3rd Cir. 1973), *cert. denied*, 415 U.S. 990 (1974), and which the Third Circuit reaffirmed in the different circumstances of *In re Penn Central Transportation Co.*, 553 F.2d 12 (3rd Cir. 1977). *See* 600 F.2d at 310-12.

On this appeal the interlining railroads argue, first, that since the interlining of freight cars is mandatory under the Interstate Commerce Act, 49 U.S.C. §§ 1(4), (10), (11), (14), (15), and (17), equity and considerations of national transportation policy unite to require that the roads receive just and reasonable compensation for the compelled loan of freight

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[3] 19 U.S.C. § 1(17)(a) provides that if "any carrier, receiver, or operating trustee" fails or refuses to comply with any order or direction of the ICC as to car service it shall be liable to stated penalties, recoverable in a civil action brought by the United States. Citations are to the Interstate Commerce Act, as amended, 49 U.S.C. § 1, *et seq.* (1976). Parallel sections respecting car service are now comprised in 49 U.S.C. § 11121, *et seq.*

[4] The court found in the terms of the Bankruptcy Reform Act provision, 11 U.S.C. § 1166, a resolution of any supposed contradiction between Section 77(c)(2) and Section 77 (l) in the requirement that both the ICC and the reorganization court approve payment for both pre- and post-reorganization per diem charges. The Congress in adopting Section 1166 rejected a Senate provision requiring the debtor to pay in cash current balances owed other carriers for interlining charges, including incentive per diems, for periods both before and after the filing of the petition.

cars; it is argued that the rail car fleet cannot be maintained at the level essential to adequate rail service unless payment of car hire is assured even in the case of the railroads that are in reorganization. The argument is essentially that made on the earlier appeal, and, so far as concerns the per diem claims for the period 1953 to August 1, 1969, is disposed of by what was then decided: the per diem claims for that sixteen year period were not based on an ICC order fixing rates and ordering payment at those rates; the ICC in *Chicago, B. & Q.R.R.* v. *New York, S. & W.R.R.*, 332 I.C.C. 176, 183, 244-57 (1968),[5] did, indeed, make findings as to the reasonableness of the rates charged for the preceding fifteen years, but those findings, it stated, were "of significance only as an aid to the courts in settling the amount of damages in the pending lawsuits" (*id.* at 183).[6]

The unpaid per diem charges for car use during the period August 1, 1969, to March 12, 1970, the date on which the reorganization proceeding commenced, aggregated $564,000; they were imposed at the rate determined by the order of the ICC, *Chicago, B. & Q. R.R.* v. *New York, S. & W. R.R.*, *supra*, 332 I.C.C. at 259; that order became final upon the Supreme Court's affirmance of the district court decisions

[5] The background and course of the litigation are outlined in the district court's decision in the "immediate payment" case, *In re Boston & Maine Corp.*, 456 F. Supp. at 413 n.2.

[6] In the suit to recover from the Boston & Maine and other railroads the difference between the amounts paid and the higher charges fixed by the Association of American Railroads, the district court deferred to the ICC's determination of the reasonableness of the AAR rates. *Baltimore & O. R.R.* v. *N.Y., N.H. & H. R.R. Co.*, 196 F. Supp. 724, 748-49 (S.D.N.Y. 1961). The ICC decision, *Chicago, B. & Q. R.R.* v. *New York, S.&W. R.R.*, 332 I.C.C. 176 (1968), fixing rates for the period commencing October 1, 1968, and making findings on the reasonableness of the rates for the 1953-1968 period, was sustained, *Boston & M. R.R.* v. *United States*, 297 F. Supp. 615 (D. Mass.), and *Union Pacific R.R.* v. *United States*, 300 F. Supp. 318 (D. Neb.), both *aff'd., without opinion*, 396 U.S. 27 (1969).

dismissing the railroads' actions to set the order aside,[7] and it was made effective August 1, 1969. This court's decision on the earlier appeal is dispositive of all the contentions raised on the present appeal as to this portion of the per diem claims except the constitutional argument. While Chief Judge Coffin's opinion was occasioned by the "immediate payment" contention of the railroads, it dealt directly and necessarily with the underlying issues of statutory interpretation and with the contention that a priority in reorganization for per diem claims would, by furnishing to the railroads an incentive for overcoming the chronic shortage of freight cars, better serve the interest of national transportation policy than would denying the priority in the interest of preserving the public service viability of bankrupt roads.

The railroads argue, on the constitutional issue, that since Congress has mandated the interline loan of cars and the ICC has fixed the per diem rates to be paid for the cars lent, denying to the car-owning railroads such a priority as will assure payment of the per diem claims in reorganization effects a taking of their property without due process of law, an unconstitutional taking akin to that found in *Chicago, R.I., & P. Ry.* v. *United States*, 284 U.S. 80, 96-100 (1931); there a divided court invalidated that part of the ICC order in *Rules for Car-hire Settlement*, 160 I.C.C. 369, 386-395, 445 (1930), that granted to the short line railroads two days of free time for interchanged loaded cars and denied compensation altogether in the case of cars received for return loading with coal from mines customarily dependent upon connecting carriers for car supply. The Court put the decision on the ground that, since the ICC had found that the owning roads were entitled to receive reasonable compensation in the form of a daily rental for the use of their general-service freight cars when on foreign lines, and that the $1 per car day charge then in effect was such reasonable compensation, the ICC could not,

[7] *See* note 6.

without inconsistency, relieve one class of railroads of the duty to pay that reasonable compensation: "The use of railroad property is subject to public regulation, but a regulation which is so arbitrary and unreasonable as to become an infringement upon the right of ownership constitutes a violation of the due process of law clause of the Fifth Amendment." 284 U.S. at 97.[8]

The rule, thus condemned by its very terms, effected at least a partial denial of compensation for car use in every instance of an interchange of cars between trunk line and short line. However, the failure to accord a special priority in reorganization to per diem claims neither denies an entitlement nor takes either property or its use without compensation. It is rather a refusal, on a ground of statutory policy, to confer on per diem charges the special advantage of freedom from one commercial risk, the risk of becoming an unsecured claim in reorganization. Whatever might be the case if interchange of cars was enforced in circumstances in which there was certainty of non-payment, it is not the case that a scheme of regulation that effects an appropriate public purpose may not, without violation of constitutional principle, entail random losses due to extrinsic factors. *See Baltimore & O. R.R.* v. *United States*, 345 U.S. 146, 148 (1953) (carload rates on certain kinds of fresh vegetables not violative of due process *merely* because they are noncompensatory; so long as regulations do not cause railroad to lose money on its overall business "it is hard to think that it could successfully charge

[8] The railroads also cite *Chicago, M. & St. P.R.R.* v. *Wisconsin*, 238 U.S. 491 (1915), in which the Court invalidated a Wisconsin law which provided that whenever a person engaged a lower berth in a sleeping car and the upper berth in the same section was neither engaged nor occupied, the upper berth should not be let down but should remain closed until engaged or occupied. The divided court held that the statute was not a reasonable exercise of state police power but a taking of property without compensation. The statute, like the short line rule, mandated a transfer of a value without compensation in money or justifying social value.

that its property was being taken for public use without just compensation");[9] *Indiana Harbor Belt R.R.* v. *United States*, 510 F.2d 644, 650 (7th Cir.) (ICC order requiring belt line to move empty cars to repair shops without charge not an unconstitutional taking of property without just compensation absent a showing as to belt line's overall operations), *cert. denied*, 422 U.S. 1042 (1975); *Western Air Lines, Inc.* v. *CAB*, 495 F.2d 145, 152-153 (D.C. Cir. 1974) (Board's denial of operating certificate to carrier that sought to operate only over profitable routes justified by consideration that supra-competitive profits of a single carrier already serving the route would enable it to undertake unprofitable local service that required such subsidization).

The railroads' contention must be considered strictly in terms of the necessary impact of the rules for car-hire settlement in the case of per diem claims against railroads in reorganization. But no extension of credit to insolvent railroads is inherent in the rules for car-hire settlement; the Commission in *Rules for Car-hire Settlement, supra*,[10] approved the rule of the "car service and per diem agreement" among the subscribing railroads which required that the car owner be furnished with a per diem statement within forty days after the end of each calendar month giving the number of days each car has been in the possession of the reporting road; the Commission noted that customarily the car owner, upon receipt of that information, drew on the using line for the amount reported after deducting per diems, if any, owed

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[9] *Government of Guam* v. *FMC*, 329 F.2d 251, 254 (D.C. Cir. 1964), and *Pan American World Airways, Inc.* v. *CAB*, 256 F.2d 711 (D.C. Cir. 1958), reach the same result on parallel facts. *Government of Guam* spoke of the result as deriving from "the compelling obligation of the carrier to render public service."

[10] An order giving effect to the findings of *Rules for Car-hire Settlement* was entered in *Rules for Car-hire Settlement*, 165 I.C.C. 495 (1930), *aff'd in part, reversed in part, Chicago, R.I. & P. Ry.* v. *United States*, 284 U.S. 80 (1931).

the other carrier. The accumulation of charges beyond the forty days was the product of the interminable controversy over rates, not a necessary consequence of interlining freight cars; the modest credit term implicit in the car-hire settlement rules could hardly be much shortened, and, given the importance of interchanging cars to the owning railroads' earning of freight revenue, the credit risk involved is not different from that generally incident to the conduct of industrial and commercial business. That some per diems of such short date may go unpaid in some railroad reorganizations, and that the loan of cars is required by law, do not combine to show a taking without just compensation. What must be shown to demonstrate unconstitutionality, and is not shown, is that the regulatory scheme as a whole, not excluding the incidence of the loss in reorganization cases arising from the extensions of credit required by the settlement rules, operates to take the property of the car-owning roads without just compensation, or is so unreasonable or arbitrary that it violates due process. The interline car-service rules and practices have evolved pragmatically in reasoned stages with but one only partly successful constitutional challenge (*Chicago, R.I. & P. Ry.* v. *United States, supra*) from the beginning position that a railroad could refuse to send its cars beyond its line when there was a car shortage since its first duty was to the business of its line, *Riddle, Dean & Co.* v. *Pittsburgh & Lake Erie R.R.*, 1 I.C.C. 374, 388 (1888); through the critical decision that local traffic does not enjoy rights superior to through traffic and that carriers must make reasonable rules and regulations with respect to the operation of through routes and the exchange, interchange and return of cars used on these routes, *Missouri & Illinois Coal Co.* v. *Illinois Central R.R.*, 22 I.C.C. 39, 48-49 (1911); to the later comprehensive ICC review and implementation of general car service standards in *Rules for Car-hire Settlement, supra*, and the succession of ICC orders of more recent years. In *Chicago, B. & Q. R.R.* v.

New York, S. & W. R.R., 332 I.C.C. 176 (1968),[11] the Commission, accepting the concept that car hire should be enough reasonably to compensate the owner for its costs of ownership and no more,[12] concluded that per diem charges should constitute no more than a sharing of cost, and should not include any amount for the value of the use of a car. *Id.* at 186-87.[13]

Bad debt losses of the car-owning railroads in rail reorganizations are simply elements of cost incident to the massive system of interchanging freight cars, and unless the system as a whole is shown to burden the car-owning railroads unreasonably or arbitrarily or to deny them overall reasonable compensation for the mandated loan of their cars, there is no transgression of constitutional right. No such showing was attempted, nor is it suggested that it could be made.

II

The claims for which priority is asserted under the "Six Months Rule" do not exceed $3,000,000 and include per diems for the period commencing September 13, 1969; priority is also claimed for the greater part of the same claims under the "Necessity of Payment" rule, but for some $400,000 of claims priority is sought under the Necessity of Payment rule only.

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[11] For the history of the ICC decision *see* note 6, *supra*.

[12] *Boston & Maine R.R.* v. *United States*, 162 F. Supp. 289, 295 (D. Mass.), *appeal dismissed*, 358 U.S. 68 (1958), is to the same effect.

[13] More recent decisions have sustained further ICC action respecting interchange of cars. *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742 (1972), approved as reasonable under Section 1(14)(a) two car service rules promulgated in 1969 by the Commission which required freight cars, after being unloaded, to be returned in the direction of the lines of the road owning the cars. The Court, reviewing the car service history of the railroads, said that, "The freight cars of the Nation thus became in essence a common pool, used by all roads." *Id.* at 743. And in *Ann Arbor R.R.* v. *United States*, 368 F. Supp. 101, 112-13 (E.D. Pa. 1973), *aff'd without opinion*, 419 U.S. 807 (1974), the courts sustained the Commission's incentive per diem rules under the 1966 amendment to Section 1(14)(a).

The district court held that to establish a priority under the Six Months Rule the creditor had to show that its claim was for a necessarily incurred current operating expense of the railroad, that it accrued within the six months preceding the filing of the reorganization petition, and that the goods or services were furnished in the expectation of payment from current railway operating revenues and not in reliance on the railroad's general credit. 468 F. Supp. at 1002. The court held further that the creditor had to show that there existed a fund in which qualifying six months claims would have a priority, that is, a "current debt (or expense) fund" comprised of current earnings of the six months period and during the reorganization or, absent a surplus of such earnings, corpus of the reorganization estate to the extent that such earnings have been diverted to it for the benefit of the railroad's mortgagees.[14] *Id.* at 1002-1005. The court concluded from the evidence that, treating depreciation as properly deductible in determining the amount of surplus earnings available for a "current debt fund," no surplus revenues had accrued either in the six months preceding the filing of the reorganization petition or during the reorganization proceeding; that, in addition, contributions to railway operating income and to the reduction of railway operating expenses had been made from the proceeds of sales of mortgaged property and from sales of scrap derived from mortgaged property; and that, finally, even if the net railway operating deficit for the relevant period, $42.5 million, were reduced by disallowing capital expenditures for property and improvements of $12.9 million, payments of pre-reorganization secured obligations of $5.6

[14] The district court held that Six Months Rule creditors were not entitled to a priority in unmortgaged assets; the court declined to follow dicta indicating a contrary assumption in *In re New York, N.H. & H. R.R.*, 278 F. Supp. 592, 598 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), and in *In re Penn Central Transp. Co.*, 458 F. Supp. 1234, 1321 n. 81 (E.D. Pa. 1978). 468 F. Supp. at 1007-08.

million, and estimated six months claims of $3 million, there would remain a net railway operating deficit of $21 million and an adjusted deficit in income available for fixed charges of $11.7 million. *Id.* at 1005-07. The district court rejected the claim for priority under the "Necessity of Payment" rule on the ground that the rule was not one of priority but of payment, and that it is inapplicable where, as in the present case, no creditor claiming under the rule had demanded payment of its claim as a condition to providing goods or services to the debtor, and the trustees never sought authority to pay the claims. *Id.* at 1008.

A

The Six Months Rule was recognized but not given precision of definition in one sentence in Section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1976):

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.[15]

The Six Months Rule emerged out of the practice of initiating railroad receiverships with an order appointing a receiver and authorizing or directing him to pay from operating receipts certain expenses incurred in the period immediately preceding the receivership. Thus the 1867 receivership order in *Gurney* v. *Atlantic & Great Western Ry.*, 58 N.Y. 358 (1874), directed the receiver to pay and discharge out

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[15] When first enacted in 1933, 47 Stat. 1474, the provision appeared in Section 77(c), and the first part read:

> For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver . . .

The language of the 1978 Act, 11 U.S.C. § 1171(b), is the same in substance as that of Section 77(b).

of the balance of receipts, after paying the expenses of maintaining and operating the road, arrearages owing to laborers and employees for work in connection with the railway and such sums as were actually due for material and supplies furnished for the use of the company's railways. No general principle, analogous to that in admiralty, was thought to give priority to the last creditors who furnished necessary repairs and supplies to a railroad. *Galveston, H.&H. R.R.* v. *Cowdrey*, 78 U.S. (11 Wall.) 459, 480-82 (1871). As the court said in *Duncan* v. *Mobile & O.R.R.*, 8 F.Cas. 17, 19 (C.C. S.D. Ala. 1876) (No. 4,137):

> The fact that the floating debt was contracted in good faith for the benefit of the railroad company's property, and therefore for the benefit of the bondholders, is true of perhaps all such debts. But that does not give the floating debt creditors any ground upon which to claim that their debt should be paid first.

Nevertheless, receivership orders continued to authorize payment of wage and supply claims that accrued over various periods, ranging up to eight months before receivership. *E.g. Skiddy* v. *Atlantic M. & O.R.R.*, 22 F. Cas. 274, 279-80 (C.C.E.D. Va. 1879) (No. 12,922) (reciting terms of 1876 receivership order); *Taylor* v. *Philadelphia & Reading Co.*, 7 F. 377 (C.C.E.D. Pa. 1880) (reviewing terms of several pre-*Fosdick* receivership orders). On the eve of *Fosdick* v. *Schall*, 99 U.S. 235 (1879), the practice of allowing payment for operating expenses of the pre-receivership period was stated in broad terms in *Turner* v. *Indianapolis, B. & W. Ry.*, 24 F. Cas. 366 (C.C.D. Ind., S.D. Ill. 1878) (No. 14,258); the court observed that generally railroads were dilapidated when receivership started, the first receipts were used to rehabilitate the road, and the pre-receivership claims for labor and supplies were paid by later order; the court emphasized that a railway is a matter of public concern and that public as well as private interests require its continued operation. The court said that its experience

> . . . has satisfied it that practically, it would be well nigh impossible, looking at things as they actually exist, to operate the roads by receivers without some allowance for claims of the character mentioned, existing at the time of their appointment, and that the limitation already stated [*i.e.*, to six months, by analogy to the Illinois lien statute] is not an unreasonable one, in view of all the circumstances.

24 F.Cas. at 367. But the court in *Turner* thought it desirable that the bar obtain from the Supreme Court a decision enunciating some just principle that might be a guide in such cases. *Fosdick* v. *Schall*, one of three cases argued and decided together,[16] is said to have been decided "after a general invitation had been extended to the members of the bar of [the supreme] court interested in like cases, to present briefs on the questions arising in that case." *See Atkins* v. *Petersburg R.R.*, 2 F.Cas. 90, 92 (C.C.E.D. Va. 1879) (No. 604).

Fosdick v. *Schall* rejected a conditional vendor's claim for "rent" of gondola cars for the six months preceding and several months following receivership for a number of very sufficient reasons. But the Court sought to establish a basis in principle for the payment of certain pre-receivership claims. The Court commenced by saying that a court, asked by a mortgagee to appoint a receiver in a mortgage foreclosure suit

> . . . in the exercise of a sound judicial discretion, may, as a condition of issuing the necessary order, impose such terms in reference to the payment from the income during the receivership of outstanding debts for labor, supplies, equipment, or permanent improvement of the mortgaged property as may, under the circumstances of the particular case, appear to be reasonable.

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[16] The two cases argued with *Fosdick* v. *Schall* did not deal with the Six Months Rule, but followed *Fosdick* v. *Schall* in holding that the lien of the railroad mortgage did not extend to cars, *Fosdick* v. *Car Company*, 99 U.S. 256 (1879), or locomotives, *Huidekoper* v. *Locomotive Works*, 99 U.S. 258 (1879), purchased under contracts of conditional sale.

99 U.S. at 251-52.[17] Noting that a railroad foreclosure case is rarely completed without concessions by the parties from their strict legal rights, that much of railroad business is done on credit, and that often debts for "labor, supplies, equipment and improvements" are deferred so that bond interest may be paid and disastrous foreclosure postponed, the Court continued:

> In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment, and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees.

Id. at 252-53. Saying that if the mortgagee sought the extraordinary equitable relief of receivership, it had to do equity in order to get equity, the Court continued:

[17] The 1875 receivership order in the *Fosdick* foreclosure directed the receiver to pay all debts due for labor and services rendered within the preceding three months and all debts for "engines, iron, wood, supplies, cars, or other property purchased within said period of three months for the use of the company."

We think, also, that if no such order is made when the receiver is appointed, and it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies, and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. This, not because the creditors to whom such debts are due have in law a lien upon the mortgaged property or the income, but because, in a sense, the officers of the company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders; and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which comes into its own hands as, if practicable, to restore the parties to their original equitable rights. While, ordinarily, this power is confined to the appropriation of the income of the receivership and the proceeds of moneyed assets that have been taken from the company, cases may arise where equity will require the use of the proceeds of the sale of the mortgaged property in the same way. Thus it often happens that, in the course of the administration of the cause, the court is called upon to take income which would otherwise be applied to the payment of old debts for current expenses, and use it to make permanent improvements on the fixed property, or to buy additional equipment. In this way the value of the mortgaged property is not unfrequently materially increased . . . . Under such circumstances, it is easy to see that there may sometimes be a propriety in paying back to the income from the proceeds of the sale

> what is thus again diverted from the current debt fund in order to increase the value of the property sold. The same may sometimes be true in respect to expenditures before the receivership. No fixed and inflexible rule can be laid down for the government of the courts in all cases.

Id. at 253-54. The Court emphasized that the power to compensate for diversions from the "current debt fund" rests on the fact that mortgage creditors have "got possession" of what in equity belongs to all or some of the general creditors:

> It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion.

Fosdick's principle, then, is one of mortgage law: that the mortgagee's interest attaches to *net* income, which arises only after the payment from gross earnings for all necessary operating and managing expenses, proper equipment, and useful improvements, and that, in consequence, to the extent that before or during receivership bonded interest has been paid, additional equipment provided, or lasting and valuable improvements in the mortgaged property have been made out of earnings which ought in equity to have been used to pay debts for labor, supplies and the like, the receivership court can use receivership income or, in some cases, the proceeds of sale of the mortgaged property, to pay the debts that, but for the diversion of funds, would have been paid in the ordinary course of business. *Hale* v. *Frost*, 99 U.S. 389 (1879), was decided later in the same term on the authority of *Fosdick* but without discussion; it approved the payment from net income earned during the receivership of pre-receivership claims for repair parts to equipment and for supplies furnished to the railroad's machinery department. The report is silent concerning any "diversion" of earnings to the advantage of the mortgagee before or during the receivership.

Atkins v. *Petersburg R.R.*, *supra*, professed reliance on

Fosdick, but approved the re-payment from income of the receivership of an advance made before receivership to pay arrears of wages in order to avert a strike. There was no reference to "diversion." The court said that:

> . . . it would be difficult to draw a distinction between the principles under which a court authorizes a receiver to make necessary expenses for operating a railroad and keeping it in a safe condition, and the principles embodied in the language quoted from the opinion of the supreme court, relating to sundry expenses of the railroad companies incurred before the appointment of receivers . . . . It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

2 F. Cas. at 94. And in *Taylor* v. *Philadelphia & Reading R.R.*, *supra*, the court similarly cited *Fosdick* as justifying a broad order permitting payment from income of claims for "labor, materials, etc., furnished for the operation of the road within five months" preceding receivership, 7 F. at 377-78, and as authorizing the issuance of receiver's certificates for the amounts involved so that the receivers could defer payment in case they found it necessary to apply earnings to protect valuable investments of the railroad.

Miltenberger v. *Logansport, C. & S.W. Ry.*, 106 U.S. 286 (1882), did not cite *Fosdick*. The critical issues in the case related to the circuit court's action in authorizing substantial capital expenditures to be incurred, in giving them priority over the *first* mortgage in a suit brought to foreclose the *second* mortgage on the road, and in effecting payment for the capital expenditures through first lien receiver's certificates authorized and sold before the first mortgagees sought to foreclose. The Court cited only *Wallace* v. *Loomis*, 97 U.S.

146 (1878), the cornerstone case on receiver's certificates, and *Barton* v. *Barbour*, 104 U.S. 126, 136 (1881), which cited *Wallace* v. *Loomis* for the general proposition that a court of equity may and in most cases ought to authorize the receiver to keep the road in repair and to manage and use it in the ordinary way until it can be sold to the best advantage of all interested. *Miltenberger* approved the circuit court's order directing immediate payment of interline claims for materials, repairs, and ticket and freight balances, some of which had accrued more than ninety days preceding the receivership, and charging the payments upon the earnings of the road "as with a first lien prior to all incumbrances upon" the railroad. The Court pointed out that the receiver's petition for the order stated that "payment of that class of claims was indispensable to the business of the road, and that, unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." 106 U.S. at 311.[18] The Court said:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes out of the earnings of the receivership, or even the *corpus* of the property, under the order of the court, with a priority of lien. Yet the discretion to do so should be exercised with

[18] The master who passed on the claims "disallowed several items in the receiver's accounts, claimed under the above heads, where the claims were made on the ground that the creditors threatened not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311. The next sentence appears to refer to the master's action in disallowing the claims rather than to the receiver's action in paying them. "His action, sanctioned by the court, in allowing items within the scope of the orders of the court appears to have been careful, discriminating and judicious, so far as the facts can be arrived at from the record. It cannot be affirmed that no items which accrued before the appointment of a receiver can be allowed in any case." *Ibid.*

> very great care. The payment of such debts stands, *prima facie*, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances. It is easy to see that the payment of unpaid debts for operating expenses, accrued within 90 days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs, and for unpaid ticket and freight balances, the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

106 U.S. at 311-12. *Miltenberger* is concerned, not with the "diversion" precept of *Fosdick*, but with the more general authority of the receivership court to accord priority status to pre-receivership claims in order to prevent the stoppage of a business impressed with the public interest. The case emphasizes the power of the court to effect payment of pre-receivership claims and the validity of the means it chooses to effect payment; the analysis is not in terms of the property interest of operating expense creditors in operating revenues and the limitation of the mortgagee's rights to net income, but it is in terms of paying those pre-receivership expenses that are brought within the principle of administrative expenses by their relation to the continuance of the railroad business.

The cases in the Supreme Court involving payment of pre-receivership operating expense claims which were decided in the twenty-odd years between *Miltenberger* and *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), preserved the "diversion" principle expressed in *Fosdick* without losing sight of the separate *Miltenberger* approach. *Union Trust* v. *Souther*, 107 U.S. 591 (1883), allowed a pre-receivership supply claim on *Fosdick* "diversion" grounds; but the Court noted also that the receivership court's "right to impose terms does not depend alone on whether current earnings have been used to pay the mortgage debt, principal or interest instead of current expenses" (107 U.S. at 594), citing *Miltenberger*, and it indicated that the bondholders' election, in their own interest, to leave the loss-making company in possession to operate the road after there had been a default entitling the mortgage bondholders to take possession justified the court's use of receivership income to pay the expenses of pre-receivership operation.[19] *Burnham* v. *Bowen*, 111 U.S. 776 (1884), approved the payment of claims for coal furnished for the railroad's locomotives in the months preceding receivership. The Court emphasized that the bondholders permitted the company to possess and manage the road after default and observed that the "maintenance of the road and the prosecution of its business were essential to the preservation of the security of the bondholders." 111 U.S. at 780. In *Burnham* the order appointing the receiver did not provide for the payment of pre-receivership operating expenses; however, the Court held that the use of receivership income to pay fixed charges on certain railroad structures, increasing the bondholders' security

[19] *Union Trust Co.* v. *Walker*, 107 U.S. 596 (1883), decided with *Souther*, held that a purchaser of claims of "six months" creditors could enforce the claims, not because the creditors had a lien on the property and income but "because in equity the earnings of the company constitute a fund for the payment of the expenses which their claims represent, before any income arises which ought to be applied to the discharge of the mortgage debt." 107 U.S. at 596.

at the expense of the labor and supply creditors, was a "diversion" within *Fosdick*. "So far as current-expense creditors are concerned, the court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made." 111 U.S. at 782. The Court in *Union Trust Co.* v. *Illinois Midland Ry.*, 117 U.S. 434 (1886), was primarily concerned, as in *Miltenberger*, with the validity and priority of receiver's certificates, but it affirmed the grant of priority in the corpus of the property over the bonds for wages due for the six months preceding receivership. 117 U.S. at 464-65. To an objection that the order appointing the receiver provided only for payment of current operating expenses from current income the Court answered that "the terms of these orders do not impair or exclude the ample authority which the court would otherwise have, and otherwise has, to order the claims in question to be paid out of the property itself, with priority." *Id.* at 465. *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355 (1898), affirmed a decree directing that a debt for locomotive coal delivered in the months preceding receivership be paid out of the current earnings in the hands of the receiver; the Court relied on language from *Burnham* v. *Bowen*, *supra*, and *Miltenberger*, as expressing an "equitable doctrine" the "dominant feature" of which was that a "superior equity" as against the mortgage bondholders, in income earned before and after the receiver's appointment, arises in favor of materialmen who furnish supplies essentially necessary to the continued operation of the railroad in the expectation of payment from current earnings. 170 U.S. at 367-68. The Court emphasized that, independently of the existence of any pre-receivership "diversion" of income, the equity of the coal company for payment out of income survived into the receivership, attached to the property in the receiver's possession, and, if a surplus of income arose in the receivership, entitled the coal company to demand that the

surplus be applied to payment of its claim. *Id.* at 369. The existence of that surplus the court found implicit in the fact that during receivership the road's receivers "expended for betterments on its railroad lines from the income of the roads during the receivership a sum much larger than the entire claim" of the coal company. *Id.* at 367-70. *Southern Ry.* v. *Carnegie Steel Co.*, 176 U.S. 257 (1900), affirmed a decree according priority payment for rail furnished during a period in excess of six months preceding receivership; the Court inferred that the rail was furnished for ordinary safe maintenance of existing lines;[20] the Court found that current receipts that should have been applied to payment of the steel company's claim had been applied during the receivership for the benefit of the bondholders by paying interest, sinking fund, and car trust debts and for construction and equipment.

Circuit court decisions, influenced by *Miltenberger*, clearly went beyond the *Fosdick* principle. *E.g.*, *Dow* v. *Memphis & L. R.R.*, 20 F. 260, 267 (C.C.E.D. Ark. 1884); *Blair* v. *St. Louis, H. & K. R.R.*, 22 F. 471, 472-73 (C.C.E.D. Mo. 1884). One case, in the Fourth Circuit Court of Appeals, in which Chief Justice Fuller wrote for the court, allowed the payment from the proceeds of the foreclosure sale of the road of interline claims for freight and freight balances that accrued before the appointment of the receiver. *Finance Co.* v. *Charleston, C. & C. R.R.*, 62 F. 205 (4th Cir. 1894). There were no surplus earnings before or during the receivership, nor had there been any diversion of income. The court relied on the broad terms of the order appointing

[20] A claim for extraordinary quantities of rails furnished before the receivership but outside the ordinary course of business, and for construction rather than repair, was not accorded priority. *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 315-16 (1900); *Hale* v. *Frost*, *supra*, disapproved priority payment for pre-receivership supplies furnished to the road's construction department while approving such payment for repair parts and for supplies so furnished to the road's machinery department.

the receiver, saying that it could not be construed as limited to payment out of current earnings, "especially in view of the condition of the road." 62 F. at 208. Emphasizing that the payment of such debts was related to the interest in preserving and disposing of the property as a going concern, and to the interest in the road's discharging its public duty, the court said that

> . . . such indebtedness may be given priority, notwithstanding there may have been no diversion of income, or that the order for payment was not made at the time, and as a condition, of the receiver's appointment, the necessity and propriety of making it depending upon the facts and circumstances of the particular case, and the character of the claims.

62 F. at 208.

The Supreme Court did not sweep so broadly. *St. Louis, A. & T. H. R.R.* v. *Cleveland, C.C. & I. Ry.*, 125 U.S. 658 (1888), acknowledged the authority of *Fosdick*, but it refused to accord priority over the mortgage to a claim for the rental of a leased line. The Court said that the lessor would have to show that the rent arrearage had arisen "by the diversion and misappropriation of the fund that ought to have been applied to its payment to the use and benefit of the mortgage bondholders." 125 U.S. at 674. To the extent that the Court impliedly required a showing of diversion before the receivership, it appears to be repudiated in *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, 170 U.S. at 365, 369. *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89 (1890), was a case in which there were no surplus earnings before or during the receivership, no receipts were diverted to pay mortgage interest or to improve the road, and the foreclosure sale realized only a fraction of the mortgage debt; the Court held that an unpaid conditional vendor of rolling stock, whose cars were ordered returned to him before the foreclosure sale, would not be granted a priority claim for the reasonable

rental value of the cars used during the four months of their use by a receiver appointed upon a *judgment creditor's bill*, but that such a priority would be accorded to the claims for reasonable rent for use of the cars by a successor receiver appointed at the end of the four months upon the *mortgage trustee's foreclosure bill*. The Court was critical of "an idea" which "seems to have obtained that a court appointing a receiver acquires power to give such preference [that is, preference over mortgage debts] to any general and unsecured claims." 136 U.S. at 97. But in the same year the Court in *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, 137 U.S. 171, 197 (1890), although denying priority to the claim before it, broadly restated both the *Fosdick* principle and that of *Miltenberger*. And *Kneeland* v. *Bass Foundry & Machine Works*, 140 U.S. 592 (1891), distinguished *Kneeland* v. *American Loan & Trust Co.*, *supra*, on its facts and as relating to a contract to buy rolling stock in which the vendor reserved title and reclaimed the rolling stock;[21] the Court in *Bass Foundry* affirmed an order for payment of claims for supplies furnished during the four month period for which the earlier *Kneeland* decision had rejected the reasonable rental value claim; the Court relied on *Fosdick* and *Miltenberger* and on *Union Trust Co.* v. *Souther*, *supra*. *Thomas* v. *Western Car Co.*, 149 U.S. 95 (1893), again rejected a car vendor's claim for a reasonable rental for the pre-receivership months and cited *Kneeland* v. *American Loan & Trust Co.*, but it put the decision in large part on the ground that the terms of the contract for the cars demonstrated that the vendor relied on the security of the cars themselves and not on the interposition of a court of equity.[22] 149 U.S. at 112. Similarly,

[21] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, distinguished *Kneeland* v. *American Loan & Trust Co.*on essentially the same ground. 170 U.S. at 370-71.

[22] *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.* *supra*, treated *Thomas* as decided on the ground that the car company relied on the responsibility of the railroad company and not on the interposition of a court of equity. 170 U.S. at 371-72.

Penn v. *Calhoun*, 121 U.S. 251 (1887), and, later, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298 (1900), rejected priority claims where, in the first case, the creditor took as security bonds of the railroad for twice the amount of the claim, and, in the second, the creditor had taken collateral security for part of the debt and had extended and renewed long terms of credit; in neither case could it be found that the creditor relied on the railroad's current earnings for payment.

Gregg v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), dealt with Gregg's claim for railroad ties delivered to the railroad in the month preceding the receivership; they were used principally during the receivership to maintain the railroad as a going concern, and the claim for payment was admittedly for a necessary operating expense incurred to keep and use the railroad and preserve the property in fit and safe condition. There had been no diversion of income by which the mortgagee had profited, or otherwise, and, the Court concluded, the circumstances affecting the claim were not "special." The Court said that the claim could not be charged on the *corpus* of the fund unless there was

> . . . a general rule that such claims for supplies are entitled to precedence over a lien expressly created by a mortgage recorded before the contracts for supplies were made.

197 U.S. at 186-87. The Court said that

> . . . we are of opinion, for reasons that need no further statement, *Kneeland* v. *American Loan & Trust Co.*, 136 U.S. 89, 97, that the general rule is the other way, and has been recognized as being the other way by this court.

197 U.S. at 187. Of the allowance of pre-receivership claims in *Miltenberger*, the supplier's principal reliance, the Court said:

> The ground of such allowance as was made was not merely that the supplies were necessary for the preservation of the road, but that the payment was necessary to the business of the road — a very different proposition.

Ibid. Other cases were distinguished as related to the special principle of *Miltenberger*, or as involving diversion of earnings, and cases like *Union Trust Co.* v. *Souther*, *supra*, where the receivership order authorized payment of six months claims for labor and supplies out of income, were explained as standing

> . . . on the special theory which has been developed with regard to income, and afford no authority for a charge on the body of the fund.

Id. at 188. The cases the Court cited as developing the "special theory" with regard to income are *Fosdick*, *Burnham* v. *Bowen*, *supra*, *Morgan's L. & T. R.R. & S.S. Co.* v. *Texas Central Ry.*, *supra*, *Virginia & A. Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, and *Southern Ry.* v. *Carnegie Steel Co.*, *supra*. The Court added:

> It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver, but that question is not before us here.

Ibid. The original receivership order in *Gregg* authorized the receiver to pay material and supply claims which accrued not more than six months before the receivership. Of this provision the Court said:

> But even if any words in the order authorized a charge on the corpus in order to pay claims like that of the petitioner, or a payment of them except from income, certainly there are none requiring it, or going beyond giving authority to the receiver if, for instance, he thought payments of previous debts necessary to the continued operation of the road.

Id. at 188-89.

Gregg is the last extended opinion on the Six Months Rule, and on the Necessity of Payment rule in the Supreme Court.[23]

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[23] *Baker* v. *Gold Seal Liquors, Inc.*, 417 U.S. 467, 471 n. 5 (1974), refers to the priority language of Section 77(b), to *Gregg* as to that priority, and to *St. Louis & S.F.R.R.* v. *Spiller*, 274 U.S.

The dissent clearly states the more inclusive principle that the Court's majority seemed to reject:

> And that principle has its foundation in the public interests. A railroad, from its nature and public responsibilities, must be kept a going concern. This is the supreme necessity, and affords the test of the equity invoked for the claims for supplies. It cannot depend upon diversion of income or upon the existence of income. It cannot be confined to debts contracted during the receivership. It may extend to debts contracted before the appointment of the receiver. But recognizing that there must be some limitation of time, the courts have fixed six months as the period within which preferential claims may accrue. And there is no infringement of the rights of mortgagees. Their interests are served, as those of the public are, by keeping the railroad in operation. The limitations of the rule dependent upon the conditions under which supplies are furnished are expressed in *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355, and in *Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U.S. 257.

Id. at 196.

Carbon Fuel Co. v. *Chicago, C. & L.R.R.*, 202 F. 172 (7th Cir. 1912), a case in which there was neither surplus earnings nor any diversion of income, interpreted *Gregg* as limiting *Miltenberger* to the cases in which not the supply or service furnished to the railroad but *payment* by the receiver is essential to the continuance of the business of the railroad. *See*, to the same effect, *Taylor* v. *Delaware & E.R.R.*, 213

304, 311 (1927), as stating the general six months limitation on *Fosdick* claims. *New York Dock Co.* v. *S.S. Poznan*, 274 U.S. 117, 121 (1927), stated the *Fosdick* principle as requiring payment for supplies furnished before receivership where the debtor's or receiver's use of them "has produced the earnings;" the Court considered the result to flow from the courts' self-imposed duty to require that, before distribution, expenses that have contributed to the preservation or creation of the fund in its custody should be paid.

F. 622, 624 (2d Cir. 1914), *Moore* v. *Donahoo*, 217 F. 177, 180-83 (9th Cir. 1914), *cert. denied*, 235 U.S. (1915), *Chicago & A.R.R.* v. *United States & Mexican Trust Co.*, 225 F. 940, 945 (8th Cir. 1915), and *Crane Co.* v. *Fidelity Trust Co.*, 238 F. 693, 695-96 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917).

Pennsylvania Steel Co. v. *New York City Ry.*, 216 F. 458, 470 (2d Cir. 1914), however, referred to *Gregg* as the "most striking example of the uncertainty which surrounds the whole subject." The Court allowed pre-receivership supply claims against unmortgaged assets of the railway in the absence of any "current debt fund." The court said:

> If the preference is properly rested on public policy we do not see how it can be restricted to current earnings. Such claimants should be preferred over all general creditors, and if current earnings are not sufficient to secure the preference it should be extended to the company's unmortgaged assets.

216 F. at 471. *Johnson Fare Box Co.* v. *Doyle*, 250 F.2d 656, 657 (2d Cir.), *cert. denied*, 357 U.S. 938 (1958), paraphrased with apparent approval, a district court's assertion[24] that it is very difficult to discover any principle which would account for all the decisions, and that the only generality obtainable from the cases is that the decision in each depended on its special facts.

Southern Ry. v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962), rejected the theory that *Gregg* severly limited *Miltenberger*, 301 F.2d at 852, and emphasized that, from *Miltenberger* forward, "public concern with the continued operation of the railroad has been a factor supporting the priority accorded

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[24] *In re Third Avenue Transit Corp.*, 138 F. Supp. 623 (S.D. N.Y. 1955), *aff'd on opinion below*, 230 F.2d 425 (2d Cir. 1956). *Third Avenue Transit* treated pre-receivership operating expense claims as enjoying priority only in net income of the railroad and of the receiver.

general creditors." *Id.* at 853.[25] The court accorded interline traffic balances and other interline accounts a priority in corpus over the mortgage bondholders. The court treated the time limitation, generally six months, as preventing operating claims from undermining the mortgage through secret liens. *Ibid.*

In re New York, N.H. & H. R.R., 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969) ("*New Haven*"), saw the Six Months Rule as one that over the years had been inconsistently stated and applied in decisions that lacked any harmonizing principle, so that "ambiguities must generally be resolved against those claiming the benefit of the rule." 278 F. Supp. at 595-96. The rule of *Fosdick* was summarized:

> Revenues accruing from operations should be paid first to the operations creditors whose materials and services made those revenues possible; and only after all such operational claims have been paid, should the balance be available for the benefit of the mortgagees. If any operating revenues do improperly get into the hands of the mortgagees, equity requires that those revenues be restored to the operations creditors by the mortgagees yielding them a priority. (Footnote omitted.)

278 F. Supp. at 597-98. The "surplus earnings" element of the "current debt" or "expense" fund of *Fosdick* the court defined as the sum of all operating revenues accrued during the six months period and during reorganization and which have actually been received or taken over by the trustee less depreciation and all operating expenses that have actually

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[25] The court noted its earlier statement in *Virginia Passenger & Power Co.* v. *Lane Bros.*, 174 F. 513, 516 (4th Cir. 1909), that in certain cases preferential payments have been allowed out of corpus. "One of the foundations of the principle is that the public interest requires that a railroad must be kept a 'going concern.' It does not depend, therefore, upon the diversion, or even upon the existence of income."

been paid, or are payable by the trustee, or which constitute administrative expenses.[26] *Id.* at 599. In *New Haven* the court found neither "surplus earnings," as it defined them, nor "income available for fixed charges," nor unmortgaged assets, nor any diversion to the mortgagees' advantage of current revenues to which the operations creditors were entitled, since neither the depreciation allowances nor payments on equipment trust and conditional sales obligations could be considered such diversions. *Id.* at 600-05. The court concluded that the six months creditors could not be accorded a priority in corpus over the mortgage bondholders. The court considered that *Flournoy* had confused and merged the Six Months Rule and the Necessity of Payment rule, "first enunciated in *Miltenberger*," by making necessity of payment a requirement of the Six Months Rule and eliminating diversion as a requirement of corpus invasion," directly contrary to *Gregg*. *Id.* at 602 n. 15. The court, on the supposed authority of *Gregg*, reduced *Miltenberger* to the case in which immediate payment is necessary to avert a threat to continued operation of the road, and characterized as "absurd" reliance on the Necessity of Payment rule by creditors whose claims had gone unpaid during six years of operation in reorganization. *Id.* at 602-03 n. 15.[27]

In re Tennessee Central Ry., 316 F. Supp. 1103 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972), accorded a

[26] The court differentiated its treatment of the six months earnings ("gross operating income" taken over and collected by the trustee less expense items payable on the date the petition was filed which the trustee was required to pay) from the scheme referred to in *Guaranty Trust Co.* v. *Albia Coal Co.*, 36 F.2d 34, 36 (8th Cir. 1929), that is, "gross operating income taken over or collected by the receiver less taxes accrued." 278 F. Supp. at 599.

[27] The Court of Appeals affirmed, 405 F.2d 50 (2d Cir. 1968), saying that the "current expense fund" for six months claims "is to be computed by deducting operating expenses and depreciation from current revenues." 405 F.2d at 52.

priority over mortgage bonds to claims for interline freight balances; the court found that the extensions of credit that the balances reflected averted a complete shutdown of the railroad's operation and facilitated the sale of the railroad to three other carriers which continued to operate it. The court relied in part on the special character of interline freight balances as collections for which the road had to account to connecting carriers, 316 F. Supp. at 1110, and ultimately on the circumstance that the connecting carriers' extension of credit preserved the corpus of the mortgaged railroad by maintaining it as a "going concern" and enabled the area formerly served by the railroad to enjoy continued rail services. *Id.* at 1111. The court argued that *Gregg* seemed to indicate that, where special circumstances or equities favored six months claimants, their claims might be allowed a priority in assets even in the absence of a diversion of income to the secured creditors' benefit. *Ibid.*

In re Penn Central Transp. Co., 458 F. Supp. 1234, 1319-28 (E.D. Pa. 1978), relied principally on *New Haven* as a distillation of a large number of earlier cases; the "current debt fund," the court said, included surplus income of the six months preceding reorganization as well as for the reorganization period, inclusive of non-rail income customarily made available to support rail operations; generally accepted railroad accounting principles were held applicable, depreciation being deducted from operating revenues in computing the "current expense fund." The deficit in Penn Central's income for the six months period and during reorganization exceeded the depreciation for the same period by very much more than the aggregate of the six months claims; since there was no earnings component for the *Fosdick* "current debt fund," and capital improvements for the same period (nearly four times the amount of the six months claims) were far less than the depreciation for the period, the court concluded that there

was neither enhancement of property nor "diversion."[28] 458 F. Supp. at 1325. The court rejected *Flournoy* as "discredited" and as impermissibly combining the six months and necessity rules, and treated the Necessity of Payment rule as stating the circumstance in which a court could justify entry of an order authorizing payment of a pre-reorganization creditor who invoked the sanction of refusal to furnish further supplies or services as a means of obtaining payment of his old claim.[29] *Id.* at 1326-27.

B.

The persistence of the Six Months Rule and the persistence of two distinct attitudes toward it, the one receptive and

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[28] The trustee evidently argued that $770 million spent on capital improvement should not be considered in the "diversion" calculation because the expenditure did not exceed the *increase* in depreciation reserve through charges to income in the period. The six months creditors apparently argued that this was "double dipping," taking depreciation into account twice, once to compute surplus earnings and a second time to absorb the capital expenditures' effect as a diversion to the advantage of the mortgage bondholders. The court sought to meet the argument with the statement that, if the amount of depreciation charged had actually been spent to make good the depreciation, that outlay "would not thereby have enhanced the mortgaged assets at the expense of the six months claimants." 458 F. Supp. at 1375. That, however, is, logically, a restatement of the conclusion that depreciation should be deducted in computing the earnings component of the *Fosdick* "current debt fund." The court met the argument directly by concluding that even adding back the depreciation did not produce *Fosdick* surplus earnings, leaving the capital expenditures in large part unexplained, however. *Ibid.*

[29] The court said that *In re Penn Central Transp. Co.*, 467 F.2d 100 (3d Cir. 1972), correctly stated the Necessity of Payment doctrine. The appellate court summarized the Necessity of Payment rule, an "exception to the normal deferment of payment of pre-reorganization claims until their disposition can be made part of a plan of reorganization," as permitting immediate payment where creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims are paid. 467 F.2d at 102 n.1. The appellate court intimated that a reorganization court might well have power to compel a continuance of a service sought to be withheld in order to coerce payment of an old claim. *Id.* at 102.

expansive, the other insistent upon its limitations and narrow sphere of operation, suggest the co-existence of two essentially different principles, neither of which limits the operation of the other, and both of which may operate in the same reorganization to embrace many of the same claims. The *Fosdick* rule is one of equitable restitution; in receivership the mortgagee must restore to operating creditors revenues diverted to the mortgagee's advantage; the lien of the mortgage extends to railroad revenue or income only when possession of the road and its income is demanded, pursuant to the mortgage terms after default, *Fosdick, supra,* 99 U.S. at 253; *Gilman* v. *Illinois and Mississippi Telegraph Co.*, 91 U.S. 603, 617 (1876); *Galveston, H. & H. R.R.* v. *Cowdrey, supra,* 78 U.S. (11 Wall.) at 482-83, and the lien reaches only what remains of revenue after payment of all current operating expenses. *Burnham* v. *Bowen, supra,* 111 U.S. at 782-83. The receivership furnishes the occasion and judicial means of effecting the equitable restitution, but mortgage law, not the special principles governing the administration of railroad receiverships, is the source of the right to restitution.

The second rule, elaborated and applied in *Miltenberger,* is peculiarly a principle of railroad receivership law, reflecting the view that a "railroad is authorized to be constructed more for the public good to be subserved, than for private gain . . . . It is . . . a matter of public right by which the courts, when they take possession of the property, authorize the receiver . . . in whose charge it is placed to carry on in the usual way those active operations for which it was designed and constructed, so that the public may not receive detriment by the non-user of the franchises." *Barton* v. *Barbour,* 104 U.S. 126, 135 (1881). *Miltenberger,* relied on *Wallace* v. *Loomis, supra,* 97 U.S. at 162-63, for the authority to issue receiver's certificates superior to the first mortgage lien to finance the payment of pre-receivership operating expenses, administrative expenses of the receiver and costs of new

construction, and relied on *Barton* v. *Barbour* for the public interest justification for continued operation of the railroad as a going business. 106 U.S. at 309-12. The Court said that payment of pre-receivership debts

> . . . where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

Id. at 312. The Court's rationale excludes the inference that only those creditors are entitled to priority of payment who demand immediate payment as a condition of continuing to supply a service or commodity of which they are monopolists.[30] The Court was defining the *classes* of claims payment of which was indispensable to the business of the road and which, "unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." *Id.* at 311. The Court's depiction of the disastrous consequences of failing to pay labor claims — a work stoppage[31] — or interline claims — a stoppage of traffic interchange — is directed to restricting the class of claims entitled to priority of payment to claims for those goods and services that are

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[30] As noted above, footnote 18, the special master disallowed "several items" where the claimants threatened "not to furnish any more supplies on credit unless they were paid the arrears." 106 U.S. at 311.

[31] In *Skiddy* v. *Atlantic, M. & O. R.R.*, *supra*, 22 F.Cas. at 281-82, the court, acting on such a ground, directed the receiver to pay eight months back wages to those employees only who continued in employment; claims of the remaining employees and claims for materials supplied under contracts made on the eve of receivership were denied priority. The district judge who joined in the *Skiddy* opinion evidently regarded it as overruled in its latter aspect by *Fosdick*. *Atkins* v. *Petersburg R.R.*, *supra*, 2 F. Cas. at 92.

indispensable to the continued performance of the transportation service. The point is to single out the pre-receivership expenses the payment of which although it — *prima facie* — may stand on a different principle from that governing payment of administrative expenses, "may be brought within the principle of the latter by special circumstances." *Ibid.* The test is not whether the claimant has the naked power to exert economic duress, but whether the expenses have the characteristics of those that the receiver pays from revenue as expenses of administration or pays out of the proceeds of the sale of first lien receiver's certificates. *E.g.*, *Boston & Maine Corp. Trustee's Competitive Bidding Exemption*, 347 I.C.C. 234, 235 (1971). (Sale of certificates "for meeting payroll and other expenses which, if not met, would preclude continued provision of essential railroad transportation services.") An early district court decision, authorizing the issuance of receiver's certificates, summed up the principle:

> It is enough for us that no court has ever refused to issue [receiver's] certificates when it was necessary for repairing the road or keeping it agoing as a safe road; and if it may authorize such expenditures by a receiver, it may pay them if they have been made by the company before the appointment of a receiver.

Atkins v. *Petersburg R.R.*, *supra*, 2 F. Cas. at 94.

Some decisions have, very evidently, read *Gregg* as reducing *Miltenberger* to a Necessity of Payment holding in the starkest economic duress form,[32] but *Gregg* is, rather, circumspect in

[32] With one exception, later cases in the Supreme Court that cited *Miltenberger* relied also on the equitable restitution principle of *Fosdick. Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, *supra*, 170 U.S. at 365-66; *Illinois Midland Ry.*, *supra*, 117 U.S. at 456-58; *Union Trust Co.* v. *Souther*, *supra*, 107 U.S. at 594. The exception is *Kneeland* v. *Bass Foundry & Machine Works*, *supra*, 140 U.S. at 596-97, where the claim was ordered paid out of corpus because the supplies covered by the claim "had been necessary to the continued operation of the road, and had gone into the general property covered by the mortgage" and "contributed to the preservation of the property during the receivership." Neither a surplus of earnings nor a diversion was involved.

its treatment of *Miltenberger;* it preserves the ambiguity of the *Miltenberger* language without explaining or applying it, and declines to find that Gregg's facts presented special circumstances warranting priority. The Supreme Court has since cited *Miltenberger* for the principle that claims with equities superior to the mortgagee's "may be accorded priority in payment although they arose prior to the receivership." *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940).

The criterion of priority to have intrinsic validity must be found in the nature of the claim and in the nature of the reorganization. If the claim is for a service or supply indispensable to the maintenance and operation of the railroad, and if the railroad continues to operate while in reorganization, the real difficulty is in finding a ground on which a court can fairly deny payment of a pre-reorganization expense claim indistinguishable from current administration expenses that are being paid and indistinguishable from kindred operating expenses that were incurred in the ordinary course of business by the railroad company in the months preceding reorganization and were paid by the railroad before reorganization or were paid thereafter by the trustees as liabilities arising out of the operation of the railroad. If a claim has the generally accepted characteristics of a six months claim, as stated in the district court's opinion, 468 F. Supp. at 1002, that is, (1) it represents a current operating expense necessarily incurred, (2) was incurred within six months before the reorganization petition was filed, and (3) the goods or services were delivered in the expectation that they would be paid for out of current operating revenues of the railroad, and not in reliance on the road's general credit,[33] it will inevitably be for an expense indistinguishable from and essentially contemporaneous with

[33] To the same effect are *In re Penn Central Transp. Co., supra,* 458 F. Supp. at 1321; *In re New York, N.H. & H. R.R., supra,* 278 F. Supp. at 596; *Guaranty Trust Co.* v. *Albia Coal Co., supra,* 36 F.2d at 35.

expenses paid by the railroad before reorganization, and will be indistinguishable from currently paid administration expenses. The singularity of the claim will not be either in the goods or services which it represents, nor in their contribution to the railroad's service to the public, nor in their contribution to the preservation of the fabric of the railroad, but only in the fact that it will, of course, not be paid. No principle marks current expenses paid in ordinary course on the eve of reorganization as preferences, but denial of an equivalent right to priority payment for expenses of the same kind likewise incurred on the eve of reorganization introduces an inequality of treatment that finds no justification either in the principles on which businesses are continued in operation during receivership, or in the mortgagee's lien interest. The desideratum is equality of treatment for the current operating expenses of a railroad enterprise the operations of which have continued without interruption of service, revenues and expenses. That equality is readily achieved by recognizing administration expenses as extending backward to the period preceding reorganization to the extent necessary to assure that there is continuity in the payment of indispensable operating expenses without reference to the date the petition is filed so long as the current expenses of the pre-reorganization period that are brought forward for payment conform to the strict standard established for administration expenses of the current operating class, and are not so dated as to forbid the conclusion that they are in fact current. The inequity in treatment arising out of the accidental circumstance of non-payment before the filing of the petition is eliminated.

The hostility to "six months" claims evident in *Gregg, supra*, 197 U.S. at 186-87 and *New Haven, supra*, 278 F. Supp. at 596,[34] is no doubt in some part a product of the

[34] In contrast is the support for a broad receivership principle approach successively evident in *Finance Co.* v. *Charleston C. & C. R.R., supra*, 62 F. at 208, the dissent in *Gregg, supra*,

uncertain limits of the class of claims: six months is not an inflexible time limit, and each case "must depend largely upon its special facts," *Southern Ry.* v. *Carnegie Steel Co., supra,* 176 U.S. at 292; the "surplus earnings" and the quantum of "diversion" relevant under *Fosdick* are puzzling concepts, *id.* at 294-95; *In re Penn Central Transp. Co., supra,* 278 F. Supp. at 598-601; reliance on the general credit of the railroad seems an illusory concept, *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.*, 176 U.S. 298, 316-17 (1900) (security taken upon renewal of notes given for rail); *Southern Ry.* v. *Carnegie Steel Co., supra,* 176 U.S. at 292 (if first notes given for rail contemplated payment from current earnings, seller "lost no equity merely by renewing the notes"); *Penn* v. *Calhoun*, 121 U.S. 251, 252 (1887) (bank took bonds of railroad to secure repayment of loan). But the definition of the class has been left to the courts by the Congress,[35] and when

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197 U.S. at 196, and *Flournoy, supra,* 301 F.2d at 851-52. The paragraph by which Chief Justice Waite introduced the discussion of priorities in *Fosdick, supra,* 99 U.S. at 251-52, is more easily referred to the broad receivership principle later elaborated in *Miltenberger* than to the narrow principle of equitable restitution that the following paragraphs of the opinion outline.

[35] The Commission on the Bankruptcy Laws of the United States, Report, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* King, Klee and Levin, Collier on Bankruptcy (15th Ed.), Appendix, Vol. 2, Part I, p. 270, recommended retaining the "so-called six-month priority rule according to creditors who supplied necessities to the debtor within six months prior to the filing of the petition the status of administrative expense claimants." The Commission's recommended bill, in the "Confirmation of Plan" section (9-503), included a requirement that the plan provide "for payment of all allowed claims for current operating expenses incurred by the debtor during the six months immediately preceding the filing of the petition." *Id.*, Part I, p. 288. The Senate in 1978 would have followed the Commission recommendation to provide that "traditionally accorded" priority (S. Rep. No. 95-989, 95th Cong., 2d Sess. 135-36, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5921-22), and S. 2266, 95th Cong., 1st Sess. § 1173(a) (9) (1978), required that the "Plan" include a provision for payment in cash of all allowed claims for current operating expenses during the six months preceding the filing of the petition. The House Bill, H.R. 8200,

the time comes to determine membership in the class[36] it will be for the reorganization court to determine what claims belong in the class because they represent indebtedness for ordinary and necessary current operating expenses indispensable to continued rail service of the kinds being paid currently as expenses of administration; whether the non-payment reflects an intentional extension of credit to the railroad, or the intervention of the reorganization petition before expiration of the ordinary billing and payment period, or some non-contractual indulgence or inadvertence on the part of the claimant, or deferment of payment on the part of the railroad; and whether, if the transaction giving rise to the claim had any credit term, it was compatible with a general expectation of payment from current receipts or indicated reliance on the railroad's general credit. In any event, it must be concluded that the class of creditors entitled to the priority contemplated by Section 77(b), 11 U.S.C. § 205(b) (1976), is not limited to participation in the current debt (expense) fund defined in terms of *Fosdick* equitable restitution, but extends to participation in reorganization railway operating revenues essentially on the same basis as administration expenses incurred during the reorganization period.

C.

Where payment for pre-reorganization services and supplies is claimed on the ground that the expenses are within

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95th Cong., 1st Sess. (1977), which in substance proposed to continue, as Section 1170(b), the language of former Section 77(b), and H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 424, *reprinted in* [1978] U.S. Code Cong. & Ad. News 6380, stated that "As under current law, the courts will determine the precise contours of the priority recognized by this subsection in each case." The provision enacted as 11 U.S.C. § 1171(b) follows the House Bill and substantially continues the language of Section 77(b).

[36] Since the district court disposed of the six months claims on the ground that there was no current debt fund, 468 F. Supp. at 1003, and no diversion, *id.* at 1004-06, and did not designate a priority classification for six months creditors, *id.* at 1008, the court did not refine its definition of the class, *id.* at 1002, nor set out the limitations on membership in such a class.

the principle governing the priority accorded to administration claims, questions respecting the existence of a current expense or debt fund, that is, of surplus earnings or net income, are not directly involved; the controlling considerations are those taken into account in authorizing administration expenses.

However, if payment is claimed under the *Fosdick* principle, the existence of a current debt fund must be demonstrated. The district court's analysis of the financial data, 468 F. Supp. at 1002-04, 1005-07, establishes that there were no surplus revenues but a deficit in operating income and income available for fixed charges in the period from September 13, 1969, to July 31, 1978, and that the operating deficit exceeded the amounts arguably expended to the mortgagee's advantage. However, in its analysis the district court defined the earnings (deficit) component of the current expense fund as comprising revenues less operating expenses *and depreciation*, *id.* at 1003; the court rejected the argument that providing an allowance for depreciation out of revenue enhanced the mortgaged assets and so was a diversion, *id.* at 1006-07; it indicated approval of the *New Haven* view that depreciation reflects the consumption of the railroad property through use, and that the depreciation allowance is comparable to expenditures made merely to preserve and not to increase the mortgaged assets. *Ibid. See New Haven*, *supra*, 278 F. Supp. at 604; *In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1324-25; note 28, *supra*.

Certainly the depreciation of income producing property, the exhaustion of its utility over the years of its useful life, is an objective fact.[37] It is, however, not related to ordinary

[37] When *Fosdick* was decided some railroads at least charged certain classes of additions and betterments to revenue, *see Union Pacific R.R.* v. *United States*, 99 U.S. 402, 420-22 (1879), and until the 1920s "retirement accounting" was common, that is, no annual depreciation charges were made against revenue, but when capital assets were retired their original cost was charged to revenue

repair and maintenance; it relates to the exhaustion of useful life despite regular repairs and maintenance. Depreciation is by its nature indelibly a capital charge, the cost, allocated to the accounting period, of the capital used to produce the revenue of that period. If the depreciation reserve is considered an accumulating fund, and not simply a record of the annual postings of fractions of the original capital cost, it is a fund accumulated to restore the original capital investment in money, or to provide a new capital asset. But the annual charges to revenue for depreciation of capital assets do not create a fund in specie that preserves the identity and stands in place of the depreciable asset and is subject to any mortgage that there may be on the asset. There is no suggestion that, here, the railroad did, or that, generally, railroads do undertake with their mortgage bondholders that they will use an amount equal to annual depreciation to make good — if that could be done — the physical depreciation of the mortgaged property. Something roughly like that may no doubt occur in good times as a portion of earnings each year is reinvested in the road, but such reinvestments are capital outlay for new assets themselves depreciable, and that the new investments may not exceed the depreciation charges of the same period means only that — assuming constant prices — the road is losing old capital values through use faster than it is acquiring new capital assets. In good times new capital assets acquired will often, perhaps usually, come under the after-acquired property clauses of the mortgage, and the long term mortgagee

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in the year of retirement. *See Depreciation Charges of Telephone Companies*, 118 I.C.C. 295, 302-03, 305-07 (1926) (outlining railroad practices and position); *Illinois Central R.R.* v. *I.C.C.*, 206 U.S. 441, 461-63 (1907); *cf. Kansas City Southern Ry.* v. *United States*, 231 U.S. 423, 445-48 (1913) (railroad arguing unsuccessfully that, where new roadbed and track replaced short section of old roadbed and track in order to improve grade and speed and reduce cost of service, the abandonment cost of the old track did not have to be charged to revenue).

will have a kind of slowly revolving security.[38] But first to last depreciation is related to capital, its exhaustion, and its replacement, not to its maintenance, and it is not an expenditure that affects cash flow of the accounting period.

The Boston and Maine accounts recorded an aggregate net railway operating loss in the period September 13, 1969, to December 31, 1977, of $42.5 million, and of that $33.2 million represented charges for depreciation. That amount could not represent a diversion of revenues to the mortgagee's advantage for the all-sufficient reason that it was not a current expenditure in any sense. If in the same period revenues were used for capital expenditures and to retire secured obligations (*supra* page 12), they were so used whether or not depreciation charges were made, and they had the special significance that *Fosdick* attaches to such expenditures, quite without reference to the amount of depreciation currently charged. *Fosdick* is concerned with the priority in operating revenues owed to current operating expenses. To rank depreciation charges equally with current operating expenditures in their claim upon revenue is to reject the priority that *Fosdick* recognized. The mortgage does not extend to the assets plus the depreciation reserve built up over the years against the assets, but only to the wasting asset itself. When in receivership the *Fosdick* principle intervenes, the priority of current operating expenses in revenue precludes any deferment to depreciation charges

[38] *Uniform System of Accounts for Railroad Companies*, 309 I.C.C. 289 (1959), approved the railroads' dispensing with retirement and depreciation accounting for track maintenance; observing that the useful life of the composite track structure is semipermanent in the sense that, when properly maintained, the end of its life span is unforeseeable, the I.C.C. concluded that no good purpose would be served by requiring retirement and depreciation accounting for track so long as the railroads continued to maintain existing track in proper condition through adequate replacement, as needed, of rails, ties, ballast and other material so that deterioration in track structure and impairment of the corporation's capital investment was avoided. 309 I.C.C. at 292, 296. Track maintenance illustrates the revolving security concept.

that, if allowed in the *Fosdick* calculation, would be a direct set-aside of revenue for the mortgage bondholders at the cost of the current-expense creditors. No ground exists for allowing depreciation in a *Fosdick* calculation of earnings that would not as a logical corollary require trustees' certificates to share their lien rank with the sum of the depreciation allowances recorded since March 12, 1970, for, in the ultimate sense, trustees' certificates, to the extent that they do not rest on "free assets," are a charge on the revenues from which expenses of administration, in considerable part current operating expenses, are paid.

D.

The district court rejected the appellants' contention that the Necessity of Payment rule is a rule of priority and accepted the conclusion of *New Haven*, *supra*, 278 F. Supp. at 603 n. 15, that the rule is not based on considerations of equity but is a device for handling a threat to the continued operation of the railroad *during reorganization*. 468 F. Supp. at 1008. To the extent that a strict necessity of *payment* rule has developed from the cases it would not be a rule conferring a right of recovery on the claimant but a rule of exculpation, protecting the trustee who paid under economic duress for a supply or service indispensable to continued operation of the railroad. *See In re Penn Central Transportation Co.*, *supra*, 458 F. Supp. at 1326 ("By definition, the necessity of payment rule is one to be invoked by Trustees, as justification for their decision to pay these unsecured pre-bankruptcy claims.") Under this distinct rule the district court was clearly right in its conclusion that, since no creditor claiming under that rule had insisted on payment of its claim as a condition of providing goods and services to the debtor, and since the trustees had never sought authority under the rule for payment of any such claims, the rule was inapplicable and the claims under it groundless.

E.

To summarize on this second aspect of the case, we hold:

1. The *Fosdick* principle, essentially one of equitable

restitution on principles of mortgage law, and the special principle of receivership administration that emerged in *Miltenberger* are co-existing but distinct principles.

2. The *Fosdick* principle of equitable restitution provides for payment of claims for pre-reorganization current operating expenses from and to the extent of the existence of a current debt fund determined essentially as indicated in *New Haven* and in *In re Penn Central Transportation Co., supra,* 458 F. Supp. at 1322-23, except that depreciation is not deductible in determining the amount of the income component of the current debt fund.

3. The *Miltenberger* receivership-administration principle provides for payment of claims on the same basis and from the same operating income as administration expenses for pre-reorganization current operating expenses that satisfy the strict requirements of the class, that is, that they are claims for necessary current operating expenses not furnished in reliance on the railroad's general credit.

4. The Necessity of Payment rule, as it has emerged as a distinct third principle, does not confer rights on claimants; it rather reflects the existence of a judicial power to authorize trustees in reorganization to pay claims where such payment is exacted as the price of providing goods or services indispensably necessary to continuing the rail service, and it reflects the existence of a corollary judicial power to exculpate trustees who may have made such payments in exigent circumstances without first obtaining authorization by court order.

III

It follows from what has been said that the order of the district court of March 19, 1979, must be reversed in so far as it failed to provide a separate class of creditors, with priority pursuant to Section 77(b) of the former Bankruptcy Act, 11 U.S.C. § 205(b) (1976), now 11 U.S.C. § 1171(b), and in all other respects affirmed.

Reversed in part, affirmed in all other respects, and remanded for further proceedings consistent with this decision.

APPENDIX B

PETITION FOR ORDER NO._____

DISTRICT COURT OF THE UNITED STATES
FOR THE DISTRICT OF MASSACHUSETTS

In Proceedings for the Reorganization of a Railroad

No. 70-250-M

In the Matter of:

BOSTON AND MAINE CORPORATION

DEBTOR

STIPULATION BETWEEN THE DEBTOR AND THE PARTIES TO THE PETITION OF THE CHESAPEAKE AND OHIO RAILWAY COMPANY, THE BALTIMORE AND OHIO RAILROAD COMPANY AND WESTERN MARYLAND RAILWAY SEEKING PAYMENT OF PER DIEM CLAIMS

FACT	REFERENCE
1. By petition dated March 28, 1977, the Chesapeake and Ohio Railway Company (hereinafter "C&O"), the Baltimore and Ohio Railroad Company (hereinafter "B&O"), and Western Maryland Railroad (hereinafter "WMR") have requested that this Court	Copy attached and marked Exhibit A.

FACT	REFERENCE
order the Debtor to pay pre-reorganization per diem accounts owed to the C&O, B&O and WMR.	
2. A per diem charge, simply stated, is the charge which a railroad pays for the use of another's railroad car. The practice of using another railroad's cars came into existence following the Civil War when the existing system of unloading and reloading through freight to be transported over more than one line was gradually phased out in favor of the far more efficient system of permitting loaded cars to move off the tracks of the car owning the railroad and onto the tracks of a connecting or using railroad. In other words, a system of interchanging freight when moving from the tracks of one railroad to another was replaced by a system of interchanging cars. This latter system became obligatory on all railroads in 1911, "when the Interstate Commerce Commission, under the Amended Interstate Commerce Act, decided that carriers could not refuse to permit their freight cars to pass onto rails of connecting carriers."	*Boston & Maine Railroad, et al* v. *United States of America and Interstate Commerce Commission, et al*, 162 F. Supp. 289, 291 (three judge District Court Mass. 1958), copy attached and marked Exhibit B, *Chicago, Rock Island and Pacific Railroad Co.* v. *United States*, 284 U.S. 80, 102 (1931), and cases cited, copy attached and marked Exhibit C.

FACT	REFERENCE
3. In the first years of use of the interchange system, compensation was fixed by the railroads on the basis of the mileage travelled by the cars of one road over the tracks of another. However, this basis for compensation proved unsatisfactory and, as a solution, the American Railway Association, (the predecessor of the Association of American Railroads, hereinafter "AAR") about the turn of the century and by agreement among the members thereof "established as the basis for compensation a flat sum per day for car use, regardless of the type or age of the car involved or the distance it travelled over the user's line." This flat sum became known as per diem.	*Boston & Maine Railroad, et al* v. *United States of America and Interstate Commerce Commission, et al,* 162 F. Supp. 289, 291 (three judge District Court Mass. 1958), copy attached and marked Exhibit B.
4. The AAR, along with setting rates, had established rules for determining and settling per diem interline payments between railroads.	
5. In 1930, the ICC exercised jurisdiction over the methods of reporting and settling per diem interline payments, when it made mandatory that railroads make car-hire settlements "in accordance with the per diem rules" of the AAR.	*Rules for Car-Hire Settlements,* 160 ICC 369, 444-445 165 ICC 495, copies attached and marked Exhibits D and E, respectively.

Fact	Reference
6. The Commission's order was sustained by the Supreme Court.	*Chicago, Rock Island and Pacific Railroad Co.* v. *United States*, 284 U.S. 80 (1931), copy attached and marked Exhibit C.

7. The AAR per diem rules relating to the methods of determining and settling per diem interline payments which were in effect from 1953 to date are as follows:

> Rule 11 1(a) Car hire reports shall be forwarded to car owners not later than the 10th day of the second month following that in which car hire accrued.
>
> Rule 12 The settlement of amounts accruing for the use of cars shall be made monthly without regard to reclaims pending.

The Rules also contain mechanisms for the subsequent settlement of disputes regarding errors or omissions in the monthly reports.

8. From 1953 to March 12, 1970, the Boston and Maine Railroad and each of the petitioning railroads settled accounts in accordance with the per diem rules, above referred to.

Fact	Reference
9. Prior to 1953 the level of per diem (rental) charged was determined by agreement among the members of the AAR, including the parties hereto. In 1953 the AAR sought to increase the per diem rate and the Boston and Maine Railroad (among others) refused to agree to the higher level.	
10. Complaints were filed with ICC concerning the reasonableness of the new AAR per diem rates (Docket No. 31358). In 1955 the Commission found the new AAR "per diem charges of $1.75, $2.00 and $2.40 were not in excess of reasonable compensation during the periods in which they were effective, and that the latter charge is not in excess of reasonable compensation for present use."	*Chicago B & Q. R. Co.* v. *New York S & W Rwy. Co.*, 297 ICC 291, 301 (1955), copy attached and marked Exhibit F.
11. In 1958 the Commission's decision was reversed on appeal and the case was remanded to the ICC for further proceedings.	*Boston & Maine Railroad, et al* v. *United States of America and Interstate Commerce Commission, et al*, 162 F. Supp. 289 (three judge District Court Mass. 1958), copy attached and marked Exhibit B, appeal dismissed 358 U.S. 68 (1958), copy attached and marked Exhibit G.

Fact	Reference
12. On March 24, 1959, the Commission reopened the 1955 proceeding (Docket No. 31358) in response to the mandate of the United States District Court for the District of Massachusetts and later consolidated it with other cases (Docket Nos. 33145 and 34405) instituted pursuant to Section 1(14)(a) of the Interstate Commerce Act. The Commission issued its decision in these cases on January 17, 1968. Among other things, the ICC decision of January 17, 1968, insofar as it instituted prescribed charges for the future, became effective, after having been stayed pending appeal, on September 1, 1970 with the charges being retroactive to August 1, 1969.	*Chicago B & Q R. Co.* v. *New York S & W Rwy. Co.*, 332 ICC 176 (1968), copy attached and marked Exhibit H.
13. The Commission's decision was sustained by three judge District Courts in the District of Nebraska and the District of Massachusetts and affirmed by the Supreme Court of the United States (Per Curiam) on November 10, 1969. Rehearing was denied by the Supreme Court on January 12, 1970.	*Union Pacific Railroad Co.* v. *United States*, 300 F. Supp. 318 (three judge District Court Neb. 1969) and *Boston and Maine Railroad* v. *United States*, 297 F. Supp. 615 (three judge District Court Mass. 1969), aff'd 396 U.S. 27 (1969); rehearing denied 396 U.S. 1030 (1970).

FACT	REFERENCE
	copies attached and marked Exhibits I, J, K and L, respectively
14. In 1961, while the Commission was considering the issues before it in *Chicago, B & Q. R Co.* v. *New York, S & W R. Co.*, the B&O, the WMR and 107 other railroads, not including the C&O, brought suit in the United States District Court for the Southern District of New York against the Boston and Maine Railroad and New York New Haven and Hartford RR Company to recover per diem charges established pursuant to the AAR agreements.	*Baltimore & Ohio R. Co.* v. *NY NH & H R Co.*, 196 F. Supp. 724 (S.D.N.Y. 1961), copy attached and marked Exhibit M.
15. In the proceeding in the United States District Court for the Southern District of New York, Judge Ryan rendered a decision dated July 9, 1961 and issued an order pursuant thereto dated June 15, 1962. No final judgment has been entered in this case.	Copy of order is attached and marked Exhibit N.
16. The C&O did not and has not filed suit to collect the per diem, other than in the instant case. However, the Boston and Maine Railroad agreed not to plead the statute of limitations by Agreement	A conformed copy is attached and marked Exhibit O.

FACT | REFERENCE

dated August 1, 1959 until 90 days after final resolution (including final review thereof by the Courts) of the per diem cases pending before the ICC.

17. During the period from 1953 to March 12, 1970, the Boston and Maine Railroad submitted its reports to each of the petitioning railroads at the per diem figure which was in effect prior to the increases in 1953 which the Boston and Maine Railroad and others refused to pay. Each of the petitioning railroads drew drafts at the figure the Boston and Maine Railroad reported and, in addition, submitted statements setting forth the difference between the drafted amounts and the amounts due as computed at the then current AAR rates.

18. The following figures represent the moneys which would have been paid, in excess of what has been paid by the Boston and Maine Railroad for the use of the cars of the B&O, the C&O and the WMR from August 1, 1953 to March 12, 1970, if the rates set forth by the Interstate Commerce Commission in *Chicago, B & Q R. Co.* v. *New York, S & W Rwy. Co.*, 332 ICC 176 (1968) are applied:

PER DIEM CLAIMS

Year	Due B&O	Due C&O	Due WMR
1953 Aug. 1 - Dec. 31	$ 2,851.32	$ 2,865.72	$ 752.52
1954	23,296.68	19,807.21	5,523.73
1955	(6,282.96)	(4,865.68)	(1,320.16)
1956	(3,933.40)	(2,402.84)	(740.80)
1957	8,572.20	5,578.20	2,197.32
1958	46,318.20	24,697.80	9,697.80
1959	35,353.12	19,919.24	6,548.96
1960	43,189.50	19,006.00	9,111.50
1961	49,943.80	23,107.78	19,221.78
1962	68,428.12	21,157.64	16,692.64
1963	42,771.00	15,410.50	9,384.50
1964	58,394.01	26,193.09	13,931.10
1965	58,416.80	30,031.68	13,626.76
1966	58,687.34	35,275.44	19,367.09
1967	91,903.36	52,380.40	22,435.92
1968	79,631.25	60,152.40	24,553.55
1969 Jan. 1 - July 31	70,567.50	48,125.58	18,226.30
	728,107.84	396,440.16	189,210.51
1969 Aug. 1-Mar. 12, 1970	35,088.72	28,934.64	7,326.55
Total	$763,196.56	$425,374.80	$196,537.06

Fact	Reference
19. In the *Matter of Chicago, Rock Island and Pacific Railroad Company*, 537 F.2d 906 (7th Cir. 1976), at issue was whether or not the reorganization trustee was required to pay per diem charges for the months of January, February and March, 1975.	A copy is attached to the petition, which is marked Exhibit A.

The Chesapeake and Ohio Railway Company, The Baltimore and Ohio Railroad Company and Western Maryland Railway

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Charles W. Mulcahy

Nov. 15, 1977

No. 80-1196.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1980.

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
PETITIONERS,

v.

ROBERT W. MESERVE AND BENJAMIN H. LACY, TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR,
RESPONDENTS.

REPLY BRIEF FOR THE PETITIONERS.

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No. 80-1196.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1980.

CHESAPEAKE AND OHIO RAILWAY COMPANY, ET AL.,
PETITIONERS,

v.

ROBERT W. MESERVE AND BENJAMIN H. LACY, TRUSTEES OF THE BOSTON AND MAINE CORPORATION, DEBTOR,
RESPONDENTS.

REPLY BRIEF FOR THE PETITIONERS.

Introduction.

In their brief in opposition to the Petition of the Chesapeake and Ohio Railway (the "C&O"), the Baltimore and Ohio Railroad Company (the "B&O"), and the Western Maryland Railway (the "Western Maryland"), Robert W. Meserve and Benjamin H. Lacy as Trustees of the Boston and Maine Corporation ("the Trustees") joined by The First National Bank of Boston and Malcolm W. Hall as Successor Indenture Trustees argue that the principle of *res judicata* bars consideration by this Court of questions raised in the Petition and that Petitioners' taking arguments are inconsistent with the decision in *Baltimore & Ohio RR* v. *United States,* 345 U.S. 146 (1953).

Because Petitioners believe both Respondents' arguments to be mistaken, they file this reply brief pursuant to Rule 22.5 of this Court.

The portion of the decision below for which Petitioners seek review concerned the classification of creditors denying Petitioners (and other railroads) such a priority for their per diem claims as would assure their eventual payment in full. Petitioners therefore refer to the decision below, 634 F. 2d 1359 (1st Cir. Oct. 6, 1980), Petition A1-A47, as the "classification" case, and to the earlier First Circuit decision which denied the railroads immediate payment—in advance of any decision on classification of creditors or a plan of reorganization—as the "immediate payment" case. 600 F. 2d 307 (1st Cir. 1979).

Argument.

I. The Principle of *Res Judicata* Does Not Bar the Questions Raised in the Petition.

A. *Petitioners' Constitutional Issue Was Not Presented Or Decided in the Immediate Payment Case.*

When in 1979 the First Circuit Court of Appeals affirmed the district court's decision that per diem claimants were not to receive an immediate payment from the estate of the Boston & Maine Corporation in advance of the division of creditors or the approval of a plan of reorganization, there remained open the possibility that per diem claims would be paid in full in the eventual classification of creditors and approval of a plan. The postponement of further consideration of per diem claims until the division of creditors was a decision "setting the time," 600 F. 2d at 310, not the amount, of per diem claims payment.

The decision was that per diem claims would not be separately and immediately paid but that consideration of their payment would be deferred until the whole range of claims on the debtor's estate was considered. The court characterized "*timing* of payment of pre-reorganization debts" as the "core issue" of that case (emphasis supplied). 600 F. 2d at 309. See also 600 F. 2d at 310 (scheduling), 313. Priorities in the sense of ranking the creditors of the estate were not determined in the district court decision which the First Circuit considered in its decision reported at 600 F. 2d 307.[1] See *In re Boston and Maine Corp.*, 468 F. Supp. 996, 999 (D. Mass. 1979). Nor was the related decision, awarding or denying creditors portions of their claims, made in the immediate payment case.

Therefore, the constitutional issue whether a taking of property was effected by the reorganization court's decision could not and would not be presented, nor would it be ripe for consideration until some decision denying payment of the per diem claims had been made. Such a denial did not occur until in the classification case the court assigned per diem claims to the lowest category of creditors' priorities, *In re Boston and Maine Corp.*, 468 F. Supp. 996, 1009 (D. Mass. 1979). That judicial action fixing the division of creditors determined that the pre-1953 rates paid by the Boston & Maine between 1953

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[1] It is specious to argue that because the district court classification decision was made March 12, 1979, and the immediate payment case arguments on appeal were heard by the Court of Appeals on April 5, 1979, that the legal questions of the classification decision by the district court were somehow to be imported into the appeal of the immediate payment decision. The two cases were separate. The appellants and the courts quite properly addressed them each in turn. That the district court decision in the classification case was made before the oral argument of the appeal of the immediate payment case was heard impairs the distinction between the cases not at all.

and 1969 would not be supplemented by payment of the increment between those rates and the rates which the Interstate Commerce Commission (the "ICC") determined to be reasonable rates for the claims Petitioners the B&O, the Western Maryland and others had lodged in their suit against the Boston & Maine in the federal district court in New York. After the classification decision, the best that Petitioners could hope for was payment of a small portion of their claim. In the district court hearing for the classification case and in their appeal from the district court decision, Petitioners duly raised the constitutional question posed by the assignment of that low priority and their consequent deprivation of full payment or any possibility of it.

Because the denial of immediate payment did not effect a taking, the First Circuit had no occasion to decide any constitutional questions in its 1979 decision. *Res judicata* therefore effects no bar to Petitioners' timely raising of the constitutional issue now that it is presented by the classification case.

B. *The Statutory Interpretations Made by the First Circuit below in the Classification Case Are Distinct from the Questions Decided in the 1979 Immediate Payment Case.*

In its 1979 decision that consideration of per diem claims should be deferred until all claims against the estate were being considered, the court did not determine that transportation policy forbade according to per diem claimants a creditor classification which would result in the eventual payment in full of per diem claims. It simply refused to schedule early payment of per diem claims as uniquely requiring immediate settlement without the necessity of addressing the competing claims of other creditors.

A year later, the court decided that the same reasoning could be invoked to justify a different decision: the assignment of a low priority among creditors to per diem claimants. The Petitioners have every right to seek review of that second decision and *res judicata* is no bar because the question decided was different.

II. Petitioners' Constitutional Arguments Are Consistent with the Decision of This Court in *Baltimore & Ohio RR* v. *United States*, 345 U.S. 146 (1953).

Respondents argue that a loss in the railroad's overall business must be shown before a taking without just compensation may be claimed in relation to undercompensation by more than a million dollars for the use of Petitioners' freight cars, and cite for the proposition *Baltimore & Ohio RR* v. *United States*, 345 U.S. 146 (1953) (the "B&O case") and four lower court cases. Opp. Br. 23. The same case law was cited in the decision below in support of the proposition that "a scheme of regulation that effects an appropriate public purpose may . . ., without violation of constitutional principle, entail random losses due to extrinsic factors." 634 F. 2d at 1364, Petn. 8-9.

Petitioners submit that the undercompensation for freight car use which they have suffered was systemic, not random, and was indeed a loss within the constitutional meaning of a taking as defined in *Chicago, Rock Island & Pacific Ry.* v. *United States*, 284 U.S. 80 (1931). The B&O case was not, in fact, a just compensation decision, but a due process decision. 345 U.S. at 148. Two rates were challenged there, one for carload lots of carrots with tops, the other for a limited group of other fresh vegetables such as string beans, lettuce and parsnips, both relating only to shipments from Texas to some (but not all other) states. The court made clear that the selec-

tion of these two individual rates from among all vegetable rates did not persuade it that the loss was significant in context:

> so long as a railroad is not caused by *such* regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use "without just compensation." (Emphasis supplied.)

345 U.S. at 148. The "such" referred to the court's characterization of the rate as "a cheaper transportation rate for one vegetable than for another." The court clearly considered that compensability of vegetable rates as a whole were considered by the ICC. In the case for which Petitioners now seek review, the challenged rate is for *all* freight cars loaned to the Boston & Maine, not for piecemeal extracts from a lengthy rate schedule. It does not fall within the sweep of the *B&O dictum* on which Respondents rely.

Nor does the fact pattern or legal posture of Petitioners' case correspond to that of the other four cases cited by Respondents. *Western Air Lines, Inc.* v. *CAB,* 495 F. 2d 145 (D.C. Cir. 1974) was not a taking case considering constitutional issues nor was any loss found; the court noted there that "[t]he net result of the Board's action is likely to be a gain by all carriers." 495 F. 2d at 157. *Indiana Harbor Belt RR* v. *United States,* 510 F. 2d 644 (7th Cir.), *cert. denied,* 422 U.S. 1042 (1975), like the *B&O* case, concerned piecemeal objections to a freight car movements tariff: only movement to and from repair shops of empty freight cars was concerned. 510 F. 2d at 646. *Government of Guam* v. *FMC,* 329 F. 2d 251 (D.C. Cir. 1964) related only to the rate charged for ocean transport of bulk cement, a filler cargo accepted for carriage on a space-available basis. The court made short shrift of the argument that the bulk cement rate was noncompensatory because the economic function of the low charge for bulk

cement was to render the public service of tending to reduce the charges made to other shippers. 329 F. 2d at 254. Finally, Petitioners note that *Pan American World Airways, Inc.* v. *CAB*, 256 F. 2d 711 (D.C. Cir. 1958) viewed Pan Am's Tokyo business as a unit which could be separately considered from Pan Am's entire business in considering the fairness and reasonableness of Tokyo mail rates. The *Pan Am* court in fact required revision of the rate under constitutional attack because it did not fairly reflect the costs to the carrier of the Seattle-San Francisco mail transport from which the Postmaster General benefited.

Petitioners here are seeking the same sort of remedy Pan Am sought: compensation which fairly reflects the public transportation service rendered by the use of Petitioners' cars by the Boston & Maine. The rate at which Petitioners seek to be paid is one determined by the ICC after years of investigation, study and consideration. The effect of deciding that Petitioners and other similarly-situated railroads are entitled to fair compensation for use of their cars at the rates found by the ICC in *Chicago, Burlington & Quincy RR* v. *New York, Susquehanna & Western RR*, 332 I.C.C. 176 (1968) (the *Per Diem Rates* case) would be to confirm the administrative judgment about what constituted a fair, just and compensable rate for car hire. To deny the review which Petitioners request would be to let stand the undercompensation for car hire resulting from the maverick rate, never approved by any court or the ICC, at which the Boston & Maine chose to pay for freight cars Petitioners and other railroads were required to lend it.[2] In all the cases discussed above, the

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[2] It may be questioned whether the ICC has the power to limit the application of past rates administratively determined in the *Per Diem Rates* case to use *only* as a measure of damages in a particular law suit. The ICC's task in measuring those damages was to determine what rate, under the Interstate Commerce Act, would

effect of the decisions was to accord validity, constitutional or statutory, to rates administratively determined, with the single exception of the rate correction required in the *Pan Am* case. *Indiana Harbor Belt RR* v. *United States,* 510 F. 2d 644, 649-650 (7th Cir.), *cert. denied,* 422 U.S. 1042 (1975); *Western Air Lines, Inc.* v. *CAB,* 495 F. 2d 145, 155-158 (D.C. Cir. 1974); *Government of Guam* v. *FMC,* 329 F. 2d 251, 254 (D.C. Cir. 1964) (rate for bulk cement); *Pan American World Airways, Inc.* v. *CAB,* 256 F. 2d 711 (D.C. Cir. 1958) (Tokyo mail rate except San Francisco-Seattle mail carriage portion). It is that same deference to administrative expertise and judicial attention to fairness among carriers which the cited decisions achieve which Petitioners seek in this case.

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constitute a fair, just and compensable rate. See discussion of *Baltimore & Ohio RR* v. *New York, New Haven & Hartford RR,* 196 F. Supp. 724 (S.D. N.Y. 1961) in Petn. 7-8, n.6. The three-judge court which decided *Boston & Maine RR* v. *United States,* 297 F. Supp. 612 (D. Mass. 1969) commented on the ICC decision about past rates in the *Per Diem Rates* case by saying, "[B]y finding that specific rates would be 'the just, fair, reasonable and non-discriminatory rates,' the Commission indicated that any other rates would not meet that standard." 297 F. Supp. at 619. This interpretation by the three-judge court of the *Per Diem Rates* case as finding what constituted the statutory rate supersedes the ICC's comment (quoted in the decision below, 634 F. 2d at 1363, Petn. A6) about the limited significance of its findings. Petitioners submit that payment by the Boston & Maine at $2.00 per car per day for the period 1953-1969 could not be constitutionally just compensation when the ICC found rates averaging $2.41 per car per day were "just, fair, reasonable and non-discriminatory" for the years 1953 to 1965 and the formula which the ICC designed for the years 1966 forward resulted in rates as high or higher.

Conclusion.

For all these reasons, a writ of certiorari should issue to review the confirmation below of noncompensatory per diem payments made and to be made to Petitioners and other car-owning railroads for the use of their rolling stock by the Boston & Maine.

Respectfully submitted,

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